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SECURITIES AND FUTURES

How the Markets Developed and How They Are Regulated

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Preface

Since their regulation was designed in the 1930s, securities and futures markets have continued to evolve. This evolution has been influenced by changes in

- the economic environment,
- government policies,
- technology, and
- the geographic scope of business activity.

The changes have caused previously segregated components of the financial services industry to begin competing more directly for customers who, in turn, have become more aware of differences in rates of return on their savings and investments. The new competitive atmosphere has prompted calls to the Congress from some financial organizations to examine the way financial markets are regulated.

In order to assist the Congress in its deliberations, the U.S. General Accounting Office (GAO) is presenting a series of studies analyzing various market segments, risks faced by market participants, market regulatory processes, and the nature of any impact that market changes might have. This study lays the groundwork for analyses of the changes in futures and securities markets by examining

- the historical development of those markets, including the risks that led to their current regulation;
- the economic functions they perform;
- how they are regulated; and,
- what changes are taking place in them.

In addition, this study responds to a request by Congressman Timothy Wirth, Chairman of the House Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce, that GAO study the securities industry oversight process.

As indicated in chapter 1, this study is based on work done by GAO staff at securities and futures exchanges, other self-regulatory organizations, and federal regulatory agencies. It also draws from other government and nongovernment studies and reports and from various trade publications and journals. Although much of the information from non-GAO sources has not been directly verified by GAO, this study was reviewed by officials at the major self-regulatory organizations and at government agencies, as well as by other experts in the securities and futures markets.

GAO wishes to acknowledge the cooperation of all parties involved, especially the self-regulatory organizations which are not legally required to respond to GAO requests for information.

James L. Howard for

William J. Anderson
Director

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Abbreviations

AMEX	American Stock Exchange
AP	Associated Person
APARS	Automated Price and Reporting Service
CAIS	Consumer Affairs and Information Services
CBOE	Chicago Board Options Exchange
CBT	Chicago Board of Trade
CEA	Commodity Exchange Act
CFTC	Commodity Futures Trading Commission
CME	Chicago Mercantile Exchange
CNS	Continuous Net Settlement
CPO	Commodity Pool Operator
CTA	Commodity Trading Advisor
DOT	Designated Order Turnaround system
FBI	Federal Bureau of Investigation
FCM	Futures Commission Merchant
FDIC	Federal Deposit Insurance Corporation
FRB	Federal Reserve Board
GAO	General Accounting Office
IB	Introducing Broker
ISG	Intermarket Surveillance Group
ITS	Intermarket Trading System
MOSS	Market Oversight Surveillance System
MSRB	Municipal Securities Rulemaking Board
NASD	National Association of Securities Dealers
NASDAQ	National Association of Securities Dealers Automated Quotation system
NFA	National Futures Association
NSCC	National Securities Clearing Corporation
NYSE	New York Stock Exchange
OCC	Office of the Comptroller of the Currency
OTC	over-the-counter
PER	Post Execution Reporting system
SEC	Securities and Exchange Commission
SIPC	Securities Investor Protection Corporation
SOES	Small Order Execution System
SRO	self-regulatory organization

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Introduction

Prompted by the accelerating changes occurring in recent years in the financial services industry, the General Accounting Office (GAO) has undertaken a series of studies to determine how these changes have affected and are affecting the current regulatory structure. This report is the first of several GAO reports on the securities and futures markets designed to help the Congress and public better understand the magnitude, complexity, and regulatory system of these two industries.

The securities and futures markets are governed primarily by a number of self-regulatory organizations (SRO), which, in turn, are overseen by federal agencies. This concept of industry self-regulation with government oversight—rather than direct federal regulation, such as that employed for the banking industry—developed because

- industry officials did not want excessive government involvement in market operations that could hinder innovative competition, and
- the legislative history suggests that the Congress felt self-regulation with government oversight would be more efficient and less costly to taxpayers than direct government regulation.

However, this current regulatory system is being challenged by changes occurring in the structure and conduct of the financial services industry as well as the types of new financial products being offered. Some of these changes (explained more fully in ch. 2) include the proliferation of new investment products, internationalization of the markets, and deregulation of certain segments of the financial services industry. These changes have created perceptions that securities and futures markets, as well as other segments of the industry, have become riskier.

Securities and Futures Regulation

The term "securities" encompasses a broad range of financial instruments, including stocks, corporate and treasury bonds, mutual funds, and options. Securities are traded on 10[1] exchanges, such as the New York Stock Exchange, through the National Association of Securities Dealers Automated Quotation System (NASDAQ), and in the non-NASDAQ over-the-counter securities market. Each exchange is self-regulated, as is the National Association of Securities Dealers (NASD), which regulates the over-the-counter securities market and all brokers and dealers doing securities business with the public. In addition, the Securities Investor

[1]New York Stock Exchange, American Stock Exchange, Chicago Board Options Exchange, Boston Stock Exchange, Midwest Stock Exchange Pacific Stock Exchange, Philadelphia Stock Exchange, Intermountain Stock Exchange, Cincinnati Stock Exchange, and Spokane Stock Exchange.

Protection Corporation (SIPC)—a private nonprofit membership corporation—provides financial protection for the customers of failed securities firms. The Municipal Securities Rulemaking Board (MSRB) adopts rules designed to, among other things, prevent fraud and promote fair dealings in municipal securities transactions. Finally, in the securities industry, the registered clearing agencies are SROs as well.

The securities industry self-regulatory organizations, and the securities industry as a whole, are overseen at the federal level by the Securities and Exchange Commission (SEC). Established in 1934 to curb abuses in the industry, SEC is responsible for administering federal securities laws and for developing federal regulations for the industry. SEC's overall goal is to protect the public from fraud and abuse in the securities markets. Currently, SEC has approximately 2,000 staff members located in Washington, D.C., and in nine regional offices.

Futures contracts—standard agreements to buy or sell a particular amount of a commodity at a specific time in the future—are traded in the United States on 13[2] organized exchanges. The futures exchanges are self-regulated as is the National Futures Association (NFA). The futures exchanges are membership organizations, most of which have been in existence for many years. The NFA is a relatively new industry-wide organization, created in 1981 as a nonprofit corporation to register futures professionals, conduct financial surveillance and compliance audits, arbitrate complaints against its members who deal with the public, and establish standards of professional conduct.

Futures trading has been under varying degrees of federal regulation for over 60 years. Currently, the Commodity Futures Trading Commission (CFTC), an independent regulatory agency created in 1974, oversees the futures industry and its self-regulatory organizations. CFTC has responsibility for administering federal legislation and developing comprehensive regulations in order to protect the public from fraud and manipulation in the marketplace. CFTC has a staff of about 500 located in Washington, D.C., and in four regional offices.

[2]Chicago Board of Trade, Chicago Mercantile Exchange, Mid-America Commodity Exchange, Chicago Rice and Cotton Exchange, New York Cotton Exchange, New York Futures Exchange, Commodity Exchange, Inc., Coffee, Sugar, and Cocoa Exchange, New York Mercantile Exchange, Amex Commodities Corporation, Kansas City Board of Trade, Philadelphia Board of Trade, and Minneapolis Grain Exchange.

States' Role

In addition to industry self-regulation with federal government oversight, the various states provide some oversight over both industries. For example, according to an official in SEC's Division of Market Regulation, each of the states has laws, many dating from the early 1920s, often called Blue Sky Laws, which deal with registering individual securities issues, licensing brokers, and preventing fraud and deceptive sales practices.

State oversight in the futures industry has been related to enforcement activities. In the past, state enforcement activities were limited, partially due to federal laws preempting state laws. In 1982, however, CFTC sought and received changes in the federal law which gave new impetus to states recently becoming more involved in applying state anti-fraud laws to futures transactions.

Objectives, Scope, and Methodology

We undertook this study to enable the Congress and public to better understand the magnitude and complexity of the changing securities and futures industries. In addition, because of strong congressional interest in the area, we wanted to lay the groundwork for further study. We have begun a series of reviews in the securities and futures markets concerning how well they are regulated and are also conducting several studies to determine the implications of the changes taking place in other segments of the financial services industry, such as banking and insurance. This study also responds to a request by Congressman Timothy Wirth, Chairman of the House Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce, that GAO study the securities industry oversight process.

Although GAO does not have statutory authority to review the operations of industry self-regulatory organizations, we did negotiate agreements with the SROs to obtain exchange and NASD records, files, and procedure manuals in order to document their day-to-day operations. We enjoyed good cooperation from the SROs, although we did encounter some limitations. For example, the Commodity Exchange Act prohibits the disclosure of investigative reports to anyone other than exchange officials, those subject to the investigation, the Department of Justice, and CFTC officials. Also, some of the SROs did not allow us access to

- open complaints, examinations, and investigations;
- individual staff member's salaries and evaluations;

- internal reviews and reports; and
- members or firms experiencing financial or operational problems.

The United States has 10 securities exchanges, 1 national securities association, 13 commodity futures exchanges, and 1 national futures association, all of which are SROs. We selected for review three securities exchanges, one of which trades options exclusively, the NASDAQ segment of the over-the-counter market run by the securities association, two commodity futures exchanges, and the futures association. Our selection contains a variety of SRO types, along with their corresponding clearing organizations, which handle the monetary exchange resulting from trades, and includes the SROs that have the largest volume of activity.

The bulk of our audit work concerning the securities industry was conducted at the following organizations: (1) New York Stock Exchange (NYSE); (2) National Association of Securities Dealers; (3) American Stock Exchange (AMEX); (4) Chicago Board Options Exchange (CBOE); and, (5) Securities and Exchange Commission. The volume of stock shares traded on the NYSE, AMEX, and in the NASDAQ market collectively account for approximately 90 percent of the total volume in all United States markets. We also interviewed officials at the Municipal Securities Rulemaking Board and the Securities Investor Protection Corporation.

Most of our audit work dealing with the futures industry was conducted at the (1) Chicago Board of Trade (CBT); (2) Chicago Mercantile Exchange (CME); (3) National Futures Association; and, (4) Commodity Futures Trading Commission. The combined contract trading on the CBT and CME makes up about 75 percent of the total number of contracts traded on all United States futures exchanges.

We interviewed officials at each of these exchanges and associations to determine how the various markets operate and what regulatory structures are in place in both industries. Discussions covered products, trading facilities and floor operations, rule enforcement, market surveillance, rule-making, registration, complaint processing, investigation procedures, clearing processes, and financial and sales practice examinations. Closed investigative case files were reviewed to verify whether procedures described to us by officials were reasonably accurate. We did not assess the adequacy of the investigations or the appropriateness of disciplinary actions. We also reviewed complaint, examination, and investigation manuals and written procedures, where available. We toured the exchanges and the NASD to better understand how the markets operate.

We also interviewed officials at the Chicago Mercantile Exchange's Clearing House Department, the Chicago Board of Trade Clearing Corporation, the Options Clearing Corporation, and the National Securities Clearing Corporation about their roles, organizations, and issues relating to the securities and futures industry. We reviewed their annual reports and other documents that described their operations.

We interviewed federal regulatory officials at SEC and CFTC headquarters and at the New York and Chicago regional offices to determine their respective regulatory roles and responsibilities and discussed issues facing the securities and futures industries. We reviewed their oversight inspection procedures and inspection reports. We did not, however, evaluate the inspection reports to determine if inspection procedures were being followed.

Furthermore, we interviewed officials of the Securities Industry Association, Futures Industry Association, North American Securities Administrators Association and academicians from Columbia University, New York University, Brooklyn Law School, the University of Chicago, and Ohio State University. We conducted a literature search and subsequently obtained and reviewed numerous reports, studies, and books regarding the industries.

At the state level, we interviewed officials from New York, Illinois, California, Kansas, Minnesota, Massachusetts, and Michigan about their states' regulatory roles in the securities and futures industries and the regulatory issues facing the industries from a state perspective.

Our audit work was performed between August 1984 and October 1985.

Organization of This Report

In chapter 2, we provide background information on the contemporary financial services environment to establish two fundamental points: the industry is changing in the face of a relatively static regulatory structure, and this change has caused public and congressional concern that risks existing in the securities and futures markets, as well as in other segments of the financial services industry, appear to be increasing. Chapters 3 and 5 outline the development and evolution of securities and futures markets, respectively, as well as their regulation. It is the purpose of these chapters to convey an appreciation of why these markets are currently regulated the way they are. Chapters 4 and 6 describe the day-to-day operations of the securities and futures markets and, in some detail, the self-regulatory process, and federal oversight of that

process. Collectively, chapters 3 through 6 are designed to acquaint the reader with how securities and futures markets work and how the process by which they are regulated is carried out.

How Agency Comments Were Handled

The GAO provided copies of this staff study to the CFTC and SEC, as well as to seven of the SROs covered in this study for the purpose of receiving official comments on the contained information. During the course of the comment period, GAO met with each of these nine organizations to correct any technical inaccuracies which may have been included in the original draft. We then received official comments based on the updated version of the draft from the SEC, CFTC, AMEX, NASD, CBOE, CME, and CBT which have been reproduced in their entirety and included in this study as appendixes. In general, the comments received concerning the securities industry (apps. I, II, III, and VII) verified the accuracy of the study and, in some instances, recommended expanding some of the topics contained herein. In some cases, we did change the text, and we include a disposition of all comments in the agency comments section.

In regards to the futures industry chapters of the study, the comments (apps. IV, V, and VI) addressed three specific areas of concern: (a) the study oversimplified certain aspects of the futures industry; (b) some of the statements made, although accurate, were somewhat misleading; and (c) some of the statements relating to the need for regulation of the futures markets should be sourced back to the documentation. As we have done with the securities industry comments, the disposition of the futures industry comments is contained in the agency comments section, and, in those instances noted, we changed the text to reflect the comments.

Changes in the Financial Services Industry Have Raised Concerns About Increased Risks in This Industry

The regulatory structure for the U.S. financial system in the 1930s was established at a time when financial markets were segregated. Depository institutions offered insured savings to depositors, but the permissible interest rates paid by these institutions were capped by regulation. For investors desiring higher returns and willing to accept greater risks, securities and futures markets offered products suitable to their needs. A set of laws and regulations segregated these various markets, and regulators developed expertise along industry lines.

In the late 1960s and into the 1970s, inflation and interest rates began to increase as federal deficits mounted. At the same time, an investing public that was growing in education and affluence became very sensitive to interest rates and risks posed by inflation. Perceiving these market changes, financial industry firms responded by creating new products to meet new investor needs.

These products included the asset management account and the money market mutual fund account offered by securities industry broker-dealers and investment companies. These accounts provided customers with brokerage services, higher interest than regular depository institution accounts, check writing privileges, and use of a debit card.[1] The securities and investment management industry attracted billions of dollars away from traditional banks and savings institutions whose interest rates were capped at a lower level. Thus, securities firms and depository institutions began to compete for many of the same customers, blurring the lines separating those two markets.

Market interest rates increased and began varying more widely in the late 1970s. Since the value of certain securities fluctuates with those rates, this introduced considerable market risk in otherwise high quality securities instruments such as Treasury securities and high grade corporate bonds. However, bond underwriters and other holders of financial instruments found they could successfully "hedge" those risks using futures contracts based on instruments such as mortgage-backed securities and U.S. Treasury securities. (See ch. 5, pp. 62-64, for a description of hedging.)

These new futures contracts were first approved in 1975. Since then, a variety of financial futures and options products have been introduced to help financial market investors hedge or speculate on a variety of

[1] A debit card is a device that allows a customer to make automatic deductions from his/her account for purchases.

risks. For example, futures contracts based on the movement of equity stock indexes, such as the Standard and Poor's 500 Index[2] traded at the Chicago Mercantile Exchange, were created to hedge against, or speculate on, movements in the stock market. And, as a product to compete with them, stock markets offered index-based options, allowing a customer to hedge index moves without taking a futures position. Both individuals and financial institutions began using these new products.

In their desire to attract back business lost to securities and futures firms, depository institutions pushed to develop their own products and to engage directly in activities traditionally denied them in laws and regulations. For example, depositories and their associations supported the decontrol of caps on interest they could pay and requested legislative authority to offer new competing products. The Congress acceded to this need by decontrolling deposit interest rates[3] and allowing those institutions to offer new products to compete with the securities industry.[4]

But depository institutions are pressing for the ability to further broaden their business lines. They (and some nondepository firms, too) have started to combine traditional banking and nonbanking businesses. Conglomerates are being created to offer a full range of financial services and the depository industry continues to support legislation to give it authority to offer broader lines of business.

Changing Competitive Climate Abetted by Various Technological, Economic, and Governmental Factors

Although competitive changes were spurred primarily by changes in inflation and interest rate behavior, other important factors contributed. These include: advances in information technology, internationalization of markets, increased overlap of securities and futures products, and a governmental climate more favorable to deregulation.

Advances in computer and telecommunications technology have facilitated the geographical dispersion of services, helped improve market operations, and given customers new ways to use the markets. For example, as will be further explained in chapter 3, securities exchanges at one time were established to facilitate the development of local and regional industries; as communications technology advanced, the need to

[2]The Standard and Poor's (S&P) 500 is a weighted index of the prices of stocks of 500 companies - 400 industrials, 40 utilities, 20 transportation companies, and 40 financial institutions.

[3]Depository Institutions Deregulation and Monetary Control Act of 1980 (Public Law 96-221).

[4]Garn-St Germain Depository Institutions Act of 1982 (Public Law 97-320).

rely on a local trading market was reduced significantly. The existing exchanges, located mainly in important financial centers, and the NASD, have employed data processing and communication facilities to allow customers in virtually every part of the country to know about and trade in firms located almost anywhere in the world. Because of advances in technology, businesses are no longer constrained to raising capital within their geographic locations. In fact, as discussed below, businesses can obtain funds from virtually any place in the industrialized world.

Before advances in information technology, market activity was inhibited by delays in reporting and executing trades, especially on high volume days. However, decreases in computer hardware costs and increases in computer hardware and software sophistication allow up-to-the-second quotations and trade reporting, and rapid dissemination of information to customers and the news media. The execution of orders has become more rapid as well and many more trades can be made by more people reacting faster to market activity.

Now, public customers are also beginning to use new technologies to conduct their trading. For example, some firms offer a discount brokerage service to customers who own their own personal computers. These persons can access the firms' data bases on their computers by telephone and can obtain market activity information, place orders, and receive trade confirmations at minimal cost, without directly contacting a broker.

As indicated above, another development has been the increased internationalization of securities and futures markets. Facilitated by technological factors described above, internationalization has followed the growth of world trade and the rise of multinational corporations. In a world business market, firms become more exposed to price and foreign exchange rate fluctuations worldwide. Firms conducting international transactions may hedge their exposures to foreign currency exchange fluctuations by using foreign currency futures or options contracts both of which allow the purchaser to fix a future price; Eurodollar[5] futures have traded on the International Monetary Market, a division of the CME since 1981 and, foreign currency futures were introduced there in 1972. Also, almost 400 foreign issues are traded on American markets as U.S. investors placed $4 billion into foreign stocks in 1983 (up from $247 million in 1981); foreigners, in turn, invested $5 billion in U.S. equities.

[5]A Eurodollar is a U.S. dollar on deposit outside the United States.

The reaction of market participants to internationalization has been multifaceted and has been reported in newspapers and financial publications. Some exchanges and the NASD are allowing foreign firms to join—the NYSE numbers about 30 foreign controlled brokerage firms among its approximately 600 members. The NASD has about 60 foreign controlled members among its approximately 6300 members. Likewise, companies such as IBM have their stock listed on several exchanges throughout the world. The NASD and some exchanges have established, or plan to establish, direct trading links with exchanges in foreign countries; in 1984 the Chicago Mercantile Exchange linked with the Singapore International Monetary Exchange. Also, exchanges either have or are contemplating extending trading hours to take advantage of international markets that, together, operate 24 hours a day.

Many new products have been developed in the past 15 years which overlap both the securities and futures industries. This growth of interrelated securities and futures products has changed the competitive climate involving the two industries and also gave rise to regulatory jurisdictional questions between the SEC and the CFTC.

As an example of this interrelationship of products, an individual or firm may purchase individual stocks, options on individual stocks, an option on a composite index of a group of stocks, a futures contract based on the composite index of a group of stocks, and an option on a futures contract based on a composite index of a group of stocks. More specifically, an individual or firm can purchase the stock of a single corporation which is a component of the Standard and Poor's 500 index on NYSE, AMEX, or NASD. They could also purchase an option on the same stock at AMEX or CBOE. One could also purchase an option based on the S&P 500 index at the CBOE, a futures contract based on the same index at the CME, or an option on a futures contract based on the S&P 500 index, also at the CME.

This proliferation of cross-market products, similar to those mentioned above, led to a dispute between the SEC and the CFTC as to which agency had regulatory jurisdiction over intermarket products. In December 1981, the two regulatory agencies entered into an accord, which the Congress enacted into law shortly thereafter, which outlined the jurisdiction each agency had over intermarket products.

Based on the Accord,[6] it was agreed that the SEC would regulate options on securities, options on stock groups or indexes, and options on foreign currencies traded on a national securities exchange. The CFTC, in turn, would regulate futures on certain "exempted" securities (such as Ginnie Mae certificates), futures on "broad-based" groups or indexes of securities, options on each of these types of futures products, and options on foreign currencies not traded on a national securities exchange. In addition, when the Congress enacted the Accord into law (as a 1982 Amendment to the Securities Exchange Act and a 1983 Amendment to the Commodity Exchange Act), it granted the SEC authority to disapprove new applications from exchanges introducing futures contracts based on stock groups or indexes. Since the Accord's enactment into law, the SEC and CFTC have developed guidelines and agreed on an interpretation of the statutory provisions.

In recent years, there have been moves in both the executive and legislative branches of the federal government toward changing the regulation of financial institutions and markets as exemplified by proposed legislation and task force recommendations.

In 1983, the Treasury Department developed a bill for the administration that would have allowed bank holding companies to diversify their product offerings. That bill, among other things, would have allowed those companies to engage in certain kinds of securities activities. A task force headed by the Vice President to study the structure of financial market regulation issued a report recommending, among other things, that SEC supervise offerings of securities by depository institutions. Currently, the depository regulators supervise these offerings, while SEC supervises them for other businesses.

In the Congress, bills have been introduced as well. These bills would have similarly reduced product line restrictions on financial service holding companies.

Some federal bank regulators have also advocated deregulation of services. The Federal Deposit Insurance Corporation issued a policy statement in 1982 that the Glass-Steagall Act of 1933 (prohibiting securities activities of banks) does not, by its terms, prohibit a state-chartered, insured bank which is not a member of the Federal Reserve System from

[6]This discussion of the SEC/CFTC Accord is not intended to be an exhaustive description of all its facets. For a more detailed description, see A Study of the Effects on the Economy of Trading in Futures and Options, The Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, and the Securities and Exchange Commission; December 1984, pp. III-43 - III-50.

establishing a relationship with or organizing a subsidiary that "engages in the business of using, underwriting, selling or distributing at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities." In November 1984, the FDIC established new rules allowing certain underwriting activities to subsidiaries of those banks.

The Comptroller of the Currency, who charters national banks, began chartering what are termed "nonbank banks" in the early 1980s. These are organizations that, by virtue of either not offering commercial loans or not accepting demand deposits, escape product line and geographic business restrictions of the Bank Holding Company Act of 1956. The Comptroller has received hundreds of applications from companies wishing to use that form of bank ownership to combine traditional banking and nonbanking businesses, including securities and insurance underwriting. The Comptroller's move was, by his own admission, meant to spur the Congress into enacting legislation to restructure the regulation of financial markets.

Changes Have Created Fears of New Market Risks

The continuing evolution of financial markets, having created new patterns of competition and new competitive products, also has created fears that new and perhaps unacceptable risks have been created. Though research on the potential risks is incomplete, enough anecdotal evidence exists to concern members of the Congress, market experts, and the media.

Many have pointed to recent events in the essentially unregulated U.S. government securities market as indicative of new risks. These events center on the use of repurchase agreements—or "repos"—by individuals and organizations who are relatively unsophisticated in this market. In a repo transaction, an owner of Treasury securities sells them and agrees to buy them back at a later date for a higher price that reflects, in effect, interest for the time the seller has the buyer's money. The buyer's loan is collateralized by the securities he/she buys. While market experts do not consider this a complex arrangement, some buyers have not taken adequate possession or control of the securities. These buyers have lost hundreds of millions of dollars as unregulated securities dealers, engaging in unsound and, in some cases, fraudulent activities, have gone out of business, leaving the repo buyers without either their money or the securities. School districts, municipalities, and financial institutions have lost money in this way.

Reaction to these events has been widespread. The closing of one government securities dealer led to the failure of one Ohio savings and loan association, and the effects of that failure forced the temporary closing of all privately insured thrift institutions in that state. Investigations were begun by regulators and the Congress. Experts emphasized to investors that they use more caution in using repos. These reactions culminated in extensive hearings by congressional committees, a request for GAO to undertake a major study of the Treasury securities market and its regulation, and the introduction of new legislation to change the regulation of these markets.

The dramatic growth of the futures markets, fueled by the development of new futures and options products (explained in chs. 3 and 5) has also raised the concern that unsophisticated investors may lose money from trading new products while utilizing unfamiliar trading strategies. However, concern also arose that these new products and the strategies in which investors were using them might change the character of the financial markets themselves, channeling funds away from traditional capital formation. Thus, the Congress, in 1982, required the Federal Reserve, the CFTC, and the SEC to study the effects on the economy of trading in the options and futures markets. That study concluded that, at that time, those markets were not found to have a discernible influence on capital formation.[7] Nevertheless, concerns about the disruptive effects of new market products and strategies continued.

To the extent that some of the concerns outlined above can be alleviated by a better understanding of the history, fundamental concepts, and regulation of the futures and securities markets, this study is aimed at increasing that understanding. And, as pointed out in chapter 1, it is the first in a series of studies by GAO on the newly evolving markets—futures, securities, and depository markets—to analyze the nature of new risks and their potential impact on regulatory procedures and on the overall structure of financial market regulation.

[7]A Study of the Effects on the Economy of Trading in Futures and Options, The Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, and the Securities and Exchange Commission; December 1984, p. I-17.

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Historical Development of Securities Markets and the Legal Framework of Self-Regulation

Private businesses and governmental bodies use securities of various kinds to obtain capital for their organizations. These securities—both equity securities such as capital stock and debt instruments such as bonds—are issued originally by organizations seeking funds and are resold, or traded, on the open securities markets. It is this ability to resell securities that makes many investors willing to buy them and thereby furnish capital to the organizations that need it. This resale market provides the liquidity necessary to ensure adequate capital formation.

It is in the interests of all market participants that the market is perceived as fair and orderly. If potential investors do not believe that the investment products offered in these markets provide a reasonable opportunity to make a profit, they will find investment alternatives. Part of that opportunity rests on the fact that all investors rely on market participants to comply with the applicable rules and regulations so that they can make informed decisions and have a chance to act on those decisions without fear of fraud or unfair advantages being taken by fellow investors.

Accordingly, securities markets and their regulation were developed to ensure that investors could obtain adequate, reliable information about potential investments and that fair and orderly practices were followed to execute investment decisions.

Securities Markets Developed to Aid Capital Formation

The securities market is one mechanism—along with other financial intermediaries such as commercial banks and insurance companies—for transferring funds from investors to issuers of securities to facilitate capital formation. The market also provides a mechanism for discovering the prices of securities. Furthermore, the relatively recent development of listed securities options allows investors to hedge against possible market losses.

Capital formation is required for the creation of productive facilities—such as buildings, tools, equipment, systems, services, and roads. The securities market mechanism is simply the process by which organizations seeking funds sell various securities to persons willing to loan the money, or participate in ownership, for the opportunity to make a return on their investments. Several types of securities instruments are used for this purpose:

- corporate stock (equity investments constituting a share in the firm's ownership with unlimited potential for profit or loss of all money invested);
- corporate and government bonds (debt instruments carrying a fixed rate of return over a specified time period); and
- warrants and rights (corporate securities issues allowing the buyer to purchase more shares in the future at either a fixed price (warrants) or at a discount on a new issue (rights).

In order for sellers of securities to decide how much they can raise on the market, and how much it will cost to do so, they must be able to discover what investors will pay for their securities. Conversely, prospective investors need to know what prices are available for various kinds of securities in order to gauge their opportunities for return. In most general terms, the securities trading mechanism (described in ch. 4) is a competitive one in which buyers and sellers meet and determine prevailing prices in an open forum that communicates the prices to other prospective investors as well.

An additional product offered in the securities markets is an option. An option is a right to buy (call) or sell (put) a fixed amount of a given stock at a specific price within a limited time period. Unlike the other securities instruments described above, options are not issued by the corporations seeking capital and, therefore, do not in and of themselves aid capital formation. Through the purchase of options, investors can hedge their positions or planned purchases by establishing the price they can, but do not have to, pay for a stock. An investor can protect against an adverse price movement in that stock, risking only the price of the option itself (usually much less than the price of the underlying stock).

For example, an investor might purchase an option to buy or sell a stock rather than buy the stock itself to be protected from an adverse price move of the stock. Since the option allows the investor to lock in a price that a share will cost at some time in the future (known as a strike price), the investor knows ahead of time what the cost will be. Also, since the investor is not obligated to purchase or sell the stock when an option to buy or sell has been purchased,[1] should the price move against

[1]This example describes the impact from purchasing an option to buy or sell stock. If the option to buy or sell stock is sold by an investor, the option may be exercised at any time by the purchaser of that option regardless of the seller's intention. The seller of an option also has, theoretically, an unlimited risk of loss with limited profit potential. The seller of an option receives the premium for selling the option, the maximum profit possible from selling an option. However, the seller is subject

the investor's position, he/she would simply not exercise the right to purchase or sell the stock. This way, the only loss incurred is the cost of purchasing the option rather than the loss in value of the stock itself.

Market Participants

The participants in the securities market may be grouped as issuers (or suppliers) of securities, sellers, buyers, and those who facilitate the process. The suppliers include government bodies and business firms. These organizations issue original securities for sale on the market. Buyers and sellers are both individuals and organizations who buy and sell securities for their own portfolios. In addition, institutions such as mutual funds have developed that create and maintain investment portfolios with a specified profile, and individuals may buy shares of the institutions' portfolios to take advantage of their professional management and diversification.

The market is facilitated by a variety of organizations and individuals. These facilitators, described below, help buyers and sellers enter and use the market, and help maintain fair and orderly market operations.

Investment bankers generally bring new securities into the market by purchasing whole (or partial, usually on a "best efforts" basis) issues from businesses or government agencies and reselling them to other institutions or individual investors. This is called the "primary distribution" of securities, or the "primary market." The primary investment bankers are said to be underwriting the issues. Investment bankers also help issuers analyze the market and register offerings with the SEC. Investment bankers are also broker-dealers.

Brokers and dealers trade issued securities for themselves or on behalf of others. This is sometimes referred to as the "secondary market." They research and offer advice on securities, take orders, and execute trades. (See ch. 4 for a more detailed description of a typical trade.) Other individuals may either offer advice (investment advisor) or execute orders without offering advice (discount broker). Broker-dealers prepare the necessary records of transactions and, in many cases, maintain custody of securities for their customers.

to loss if the underlying stock moves against the investor's position by more than the amount of the premium received when the option was sold as the change in value of the option tends to move in tandem with the change in value of the underlying stock.

Exchanges form convenient meeting places at which to conduct trades. They provide the facilities and systems to record, account for, and report on transactions. They also establish rules for maintaining fair and orderly markets and enforce those rules. Many stocks are not traded on exchanges but are traded on NASDAQ or are otherwise traded in the over-the-counter market. NASDAQ is a computerized communications system which provides quotation and transaction information on its eligible securities to a nationwide network of market makers (companies which maintain a portfolio of securities which they buy for or sell to investors, see p. 35). The NASD, like the exchanges, has established and enforces rules requiring that fair and orderly markets be maintained.

The final facilitators are government regulators, both state and federal. The federal regulators oversee the SROs to ensure that investors are adequately informed about entities whose securities they buy, and enforce securities laws and regulations. The state regulators enforce state securities regulations and laws within their jurisdictions.

Securities Market Development[2]

Securities markets in the United States began with the American Revolutionary War. During the war, the Continental Congress, some of the colonies, and the Continental Army all issued various forms of financial notes and scrip. After the war, the newly formed United States funded $80 million of this debt in the form of bonds. As early as May 1792, a group of 24 brokers met in New York City to sign an agreement on terms and conditions of trading these bonds and on commissions they would charge the public. These brokers reserved more favorable rates, terms, and conditions for trades among themselves. In 1817, the brokers adopted a formal constitution and called themselves the "New York Stock and Exchange Board." In 1863, the name was shortened to "New York Stock Exchange," the precursor of today's well known organization.

For a number of years, debt instruments—primarily bonds issued by the federal government—comprised most of the market activity. However, the rapidly growing transportation industry began to demand funds, spurred by the expansion of the railroads. The federal debt actually declined in the 1820s, and trading in transportation bond-type securities

[2]Information in This Section Was Taken Largely From "The Securities Industry: Securities Trading and Investment Banking," Michael Keenan, in Financial Handbook, 5th Edition; Edited by Edward I. Altman; John Wiley & Sons, 1981.

became more important. During this period, stocks began to gain popularity as trading instruments. At first, most of the equities were stocks of banks and insurance companies; later, stocks of nonfinancial companies appeared.

Two significant developments in the U.S. economy in the 1830s and 1840s influenced the development of the securities industry. First, domestic markets began supplanting European markets as sources of investment capital. Second, the discovery of gold in California gave birth to many companies that sold shares to a public willing to gamble on vast riches. This willingness persisted in spite of fraudulent mining claims and unproductive mines. But, the gold strike did expand public participation in the stock market and caused stock exchanges to be organized in the western part of the country. Although at one time the nation had more than 100 exchanges, relatively few survived.

Before the stock market crash of 1929, America's securities exchanges operated as private business clubs. While these clubs did have some internal rules and requirements, two government studies completed in the early 1900s concluded that the exchanges placed members' interests above those of the investing public. In 1909, the Hughes Commission, formed by the State of New York, noted that the comradeship among members had led the exchanges to overlook fellow members' misconduct and that the exchanges had failed to take proper measures to prevent wrongdoings. A subsequent federal investigation, conducted by a subcommittee of the House Committee on Banking and Currency, revealed that the NYSE was aware of many manipulative practices but took no actions to deal with them. In spite of these revelations, though, no major federal role was established to control abuses.

In the 1920s period of post-war prosperity, investors began looking to reap large profits with little apparent fear of inherent market risks. This era saw the proliferation of "margin buying": brokers, backed by capital loans from large corporations, offered stock to investors in exchange for a small down payment and interest on the balance of the purchase price. By 1929, 40 percent of all investors were margin buyers who pyramided hundreds of thousands of dollars in profits on relatively small investments. As stock prices declined, and brokers began calling in their margin loans, many customers were unable to raise the necessary cash without selling their shares of stock. These sales, in turn, further depressed stock prices and created a vicious circle that brought the markets to collapse.

Legislation Affecting the Securities Industry

The chaos of 1929 created a demand for federal intervention to regulate the markets and thereby restore public confidence in them. In 1932, the Senate Committee on Banking and Currency began an intensive investigation of stock market practices. That investigation concluded that due to "evils and abuses which flourished on the exchanges and their disastrous effects upon the entire nation . . . federal regulation is necessary and desirable."[3]

In 1933, Secretary of Commerce Daniel Roper was assigned by President Franklin D. Roosevelt to direct a Federal Interdepartmental Committee on stock exchanges (the Roper Committee). The Committee, which issued recommendations in January 1934, concluded that, while the exchanges might at times fail to do a good job, the role of government should be as an overseer, stepping in when the exchanges were lax in fulfilling their responsibilities. The Committee stressed the need for self-regulation with the broad authority of a central agency to oversee the process. The Committee emphasized, "It is not proposed that Government so dominate the exchanges as to deprive these organizations of initiative and responsibility, but is proposed to provide authority to move quickly and to the point when the necessity arises."[4] This perspective of regulation, it was thought, would also eliminate the danger of a potentially less responsive federal bureaucracy.

However, the first legislation proposed, the Fletcher-Rayburn bill, provided for direct governmental regulation. A federal commission was proposed, to be given extensive powers to establish standards for exchange activities. The drafters of this bill felt that these broad powers were necessary to allow for proper governmental control of complex, varied, and rapidly changing trading practices.

Market participants attacked the bill, exemplified by the then president of the New York Stock Exchange. He characterized section 18C of the bill, which gave the proposed commission the authority to prescribe rules and regulations as deemed necessary for the protection of the public, saying, "this is not regulation but domination."[5] Complaints such as this led to modifications that eventually became law in the Securities

[3]Senate report No. 1455, 73d Congress, 2d session 81 (1934).

[4]Staff of Senate Committee on Banking and Currency, 73d Congress, 2d session, Stock Exchange Regulation, Letter from President to Chairman of Committee on Banking and Currency with an Accompanying Report Relative to Stock Exchange Regulations, 6 (Comm Print 1934).

[5]Hearings on S.Res. 84, S.Res. 56, and S.Res. 97 before the Senate Committee on Banking and Currency, 73d Congress, 1st session, part 15 at 6638-39, (1934), (testimony of Richard Whitney).

Exchange Act of 1934. In the Act, the newly created Securities and Exchange Commission could request that an exchange effect specific rule changes. But, if the exchange refused, the Commission had to hold hearings to decide whether the rule changes were in the best interests of the investing public. In addition, the Commission was given no powers with regard to the methods of electing exchange officers, or the suspension, expulsion, and disciplining of exchange members.

Thus, the final form of the legislation created a governmental body with broad reserved controls available if the exchanges did not adequately carry out their responsibilities for protecting investors. This achieved the congressional desire to exercise control over the securities industry without having to expend the resources and manpower necessary with a direct regulating scheme. The legislation was also considered to be flexible enough to allow for industry-initiated innovations which direct regulation might not have allowed for.

In the following years, the Congress passed several laws that extended the authority of the Commission and provided a broader range of protections for investors. These laws included:

- The Public Utility Holding Company Act of 1935, which required registration of public utility holding companies with the SEC.
- The Maloney Act of 1938 (52 Stat. 1070), which provided for the creation of national securities associations as SROs in the over-the-counter securities market.
- The Trust Indenture Act of 1939, which established documents (trust indentures) to govern shareholders' rights and company obligations.
- The Investment Company Act of 1940, which required investment companies to register with the SEC.
- The Investment Advisors Act of 1940, which required investment advisors to register with the SEC.

Then, in 1961, the Congress directed the SEC to conduct a special study of the securities industry to assess the adequacy of the SROs' rules for protecting the investor. This study, intended from the outset to be very broad, represented the first time that self-regulation as a concept was reexamined since its formulation in the 1930s. In 1963, the Congress was presented with an extensive final report. Although the report cited over 150 specific recommendations for strengthening securities laws, the study's director reported to the SEC in 1963 "that under the stresses of its expanded role (due to the enormous growth in the markets), the

framework of regulation needs considerable adjusting and strengthening, but the basic design appears to have worked effectively in most areas."[6]

This study formed the basis for the Securities Act Amendments of 1964, one of the three major pieces of securities legislation involving self-regulatory organizations from that time to the present. As a means to adjust and strengthen the regulatory framework, the Amendments of 1964 provided for, among other things,

- extension of disclosure and insider trading protection to the over-the-counter markets;
- strengthening of standards and qualifications for securities firms and their employees; and
- tightening of the disciplinary controls of the SEC and SROs.

A second major piece of legislation was a direct outgrowth of the financial crisis on Wall Street during 1968-70 when a substantial number of major brokerage firms, including prominent NYSE member firms, either failed or were acquired by other firms to prevent their collapse. These failures caused large numbers of shareholders to lose substantial sums of money due to broker insolvency and brought with it a plunge in the market indicating a lack of public confidence. Therefore, in December of 1970, the Congress passed the Securities Investor Protection Act of 1970 which created the Securities Investor Protection Corporation.

During the hearings on this Act, some Senators voiced concerns that government-backed protection of customer accounts created by SIPC would permit the problems of the industry to continue and inhibit much needed reforms. The Committee on Banking, Housing, and Urban Affairs gave assurances that SIPC protection was necessary for reform, but would not be used as an alternative to reform. The Congress continued to explore the problems of the securities industry and, in June 1971, the Senate authorized a complete study of the securities markets and industry to be conducted by the Securities Subcommittee of the Committee on Banking, Housing, and Urban Affairs. The final report, issued in 1973, laid the foundation for the Securities Acts Amendments of 1975, a major revision of the Securities Exchange Act of 1934. The 1975 Act clarified the scope of self-regulatory responsibilities and set standards to assure that industry organizations properly exercised their

[6]Report of the Special Study of Securities Markets of the Securities and Exchange Commission, Part 1, Letters of Transmittal of April 3, 1963, page XIII.

responsibilities. In general, the 1975 Act shifted regulatory authority toward the federal government. Some of the major provisions include

- the establishment of the Municipal Securities Rulemaking Board to oversee the municipal securities industry,
- the elimination of fixed-rate commissions for brokers and dealers,
- the requirement for SEC to facilitate the development of a national market system to electronically link all securities markets making them more efficient and economical, and
- the requirement for large institutional investors to report on their portfolios of shares to measure their effect on markets.

Today, the concept of securities industry self-regulation remains much as intended by the framers of the original Securities Exchange Act. They realized the inherent dangers of giving the industry free reign, but they sought to balance industry initiative with governmental controls. The regulatory system has not always been a cooperative relationship between industry and government, but compromises have usually been reached in order to resolve the practical problems of administering a very complex and rapidly changing market.

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How Securities Are Traded and Regulated

Securities market organizations and their participants operate under a scheme of self regulation and federal government oversight. SROs and SEC combine to promote the smooth functioning of trading activity within the confines of securities laws and rules. To accomplish this, SROs facilitate trading; establish, review, and enforce standards of conduct; regulate ethical standards, business practices, and financial responsibility of members; conduct routine examinations of member firms; conduct investigations of alleged violations; and discipline violators of SRO rules or federal securities laws.

Activities of the SROs are subject to SEC oversight by way of new or amended rule approval and various inspections of the SROs to determine how well they police their members. SEC provides direct regulation by conducting independent investigations into illegal activities, prosecuting violators of securities laws, and promulgating regulations which market participants must follow.

How Securities Are Traded

Securities markets provide facilities for buyers and sellers to come together and trade financial instruments by competitive bid. As discussed in chapter 3, these markets foster capital formation, price discovery, and hedging of investment risks. Transactions on securities exchanges are conducted on the exchange floor while NASDAQ over-the-counter transactions are effected through the NASDAQ system, a network of computers, terminals, and telephones. The clearing corporations facilitate the trading process by matching completed trades and altering firms' financial positions accordingly. The Municipal Securities Rulemaking Board operates strictly as a rulemaking body.

Participants in Floor Trading of Securities

A typical trade occurring on the floor of a securities exchange involves several participants who are exchange members and who represent the purchaser, the seller, the exchange, and/or themselves. One participant is the specialist, whose primary obligation is to maintain fair and orderly markets by performing both dealer and broker functions. The exchange allocates securities to specialists who are assigned to areas called "posts," where securities are traded. The specialist can make markets for his own account when only one party to a trade is available or match trades between brokers in those securities in which he is registered to deal. Commission brokers are employed by member firms to execute orders on the exchange floor for the firm's customers. "Two dollar brokers" act as agents for commission brokers. Their role is played during active markets either by handling overflow orders for

commission brokers or acting as brokers for firms which do not have their own brokers on the floor.

Other members of the various exchanges are the registered traders, also referred to as dealers, who limit their trading activities to their personal or firm's accounts. Finally, market makers on the floor of the exchanges deal for their own accounts and may aid the specialist during heavy trading periods.

How the Floor Participants Execute Trades

On the NYSE and AMEX, trades are generally executed in the following fashion. An investor contacts a registered representative of a brokerage firm and inquires about the current price of a security. The representative obtains the latest bid and ask price for that stock and notifies the investor of such. Upon obtaining the price information, the investor determines whether or not to execute a transaction for the purchase or sale of a specified quantity of stock shares or bonds. Two general types of orders can be placed to execute a transaction. The first is an order "at the market" where the best available price is taken when the order reaches the trading floor. A second type of order, a "limit order," specifies a price at which the transaction should be consummated. When the order is finalized, the registered representative transmits the information by direct wire or teletype to the firm's order room.

Upon receipt of the order, the firm transmits the order to the exchange floor. All specialists are located at posts on the exchange floor and specific stocks are traded at each post. For those trades reaching the floor via the firm's trading booth, the firm's clerk time stamps the order on receipt and then relays it by hand, pneumatic tube, or hand signal (AMEX only) to the firm's broker on the floor. The broker goes to the specialist post where the stock is traded and determines the prevailing price. The broker may leave the order with the specialist who executes the order when appropriate, or he/she may attempt to find a better price than the specialist has by offering it to brokers at the post. Should a better price be found, the two brokers execute the trade between themselves within the established price quote.

When a bid and offer match, a trade takes place. No paper changes hands between the brokers involved in the trade. However, each broker to the transaction must note the exact details of the trade including the price, the time, the badge number of the other broker, and the other broker's clearing firm. This information is used by the exchange to

create an audit trail of transactions that occur on the floor. The initiating broker reports the trade to an exchange staff member called a reporter. The floor brokers report the execution of the trade to their respective clerks who time stamp the execution of the trade and notify their firms. The firm then notifies the customer of the trade and confirmation is sent to the customer.

A specialist can also be involved in trades as a broker's broker or as a dealer. The specialist, in his role as broker's broker, handles market and limit orders received from floor brokers or via electronic means. In this role, the specialist presents orders to the crowd. The specialist, in his role as a dealer, may be required by the exchange to execute trades for his own account to improve—in terms of price or size—the current market reflected by public bids or offers.

For transactions between specialists and floor brokers, the participants note the price per share, the badge number of the specialist and/or other broker, and the clearing firm of the specialist and/or other broker. The specialist reports all transactions in which he was involved to the reporter.

The reporter records the trade on a computer readable "mark sense" card for entry into a card reader. In a matter of seconds, the trade will be displayed on the exchange floor and to the public via "ticker tape" and other electronic communications networks, and notifications go to financial vendors and the news media.

Each party to a transaction directs his/her part of the trade through his/her respective brokerage firms, which in turn notify their clearing firms. Some brokerage firms do their own clearing (self-clearing firms) while others hire another firm to perform clearing services. Each clearing firm processes its side of the trade and forwards the information to the appropriate clearing corporation, which matches up the cash and securities involved in the trade.

In addition, both NYSE and AMEX have electronic trade execution systems for specific types of orders. At AMEX, the Post Execution Reporting (PER) system is an electronic order routing system which enables brokerage firms to transmit certain market and limit orders directly to the appropriate post on the trading floor for execution by the specialist. AUTOPER is an enhancement of PER which uses touch screen technology to execute trades and, within a matter of seconds, sends an execution report electronically to the brokerage firm.

NYSE uses the Designated Order Turnaround (DOT) system, now called Super-Dot, through which member firms transmit small orders in NYSE-listed stocks directly from their offices to the appropriate trading post on the floor and receive execution reports electronically. NYSE also uses a Limit Order System which electronically files orders that are to be executed when and if a specific price is reached, and electronically generates execution reports directly to member firms. The Automated Pricing and Reporting Service (APARS) at NYSE handles market and limit odd lot orders (less than 100 shares) and prices the orders based on the next round lot transaction that occurs after the odd lot order is received.

Both AMEX and NYSE participate in the Intermarket Trading System (ITS) which links the trading of listed stocks among the seven principal U.S. exchanges and the NASD. ITS allows any broker representing a public customer or any market professional trading for his or her own account to seek an execution in another participating market whenever a better price is available elsewhere within the ITS network.

NASDAQ Over-The-Counter Trading Process

Over-the-counter trading through the National Association of Securities Dealers Automatic Quotation (NASDAQ) system is conducted differently than trading on the exchanges. In the NASDAQ market, there is no specialist. This system consists of competing market makers who are willing to sell or buy a given security for their own account. Two market makers are required by NASD by-laws to exist for every issue, some issues have more than 30, with the average issue having eight market makers.

A trade in the over-the-counter market begins like a trade on a exchange with the investor calling up a broker (i.e., registered representative of a brokerage firm) to make an inquiry on the price of a security. The representative inquires about the security via a desk terminal which displays the best bid and offer prices of all the competing market makers in that security at the time of inquiry. If the customer places an order to buy or sell, based on the prices available, the representative directs the order to the firm's OTC trading department.

At this juncture, the order can be handled in one of two ways. First, if the firm with the customer's order makes a market itself in the security, it generally will buy from or sell to the customer from its inventory, usually at the best bid or offer in the NASDAQ system, plus or minus a mark-up or mark-down (the equivalent of a commission).

Secondly, if the firm is not a market maker in the security the customer wishes to buy or sell, the representative can engage in a transaction with one of the market makers displayed on the terminal. This is accomplished in either of two ways, depending on the terms of the purchase or sale. Like some exchanges, NASD has an automated order execution system which can be utilized when trade terms meet certain criteria. The Small Order Execution System (SOES) enables those public trades of 1000 shares or less in those NASDAQ securities designated as national market system securities, and 500 shares or less in all other NASDAQ stocks, to be executed automatically at the best bid or offer, depending on the order, available in the NASDAQ system.

For orders which are in excess of SOES maximums, or where the representative believes that a better price than that displayed on the terminal can be negotiated, he/she contacts a market maker by telephone to engage a transaction.

Market makers are required by NASD rules to buy or sell at least 100 shares of stock at its quoted price. It is possible, therefore, that larger transactions may have different prices for blocks of shares, or may have the order filled, in part, by several market makers. In addition, firms transacting customer's orders are required by NASD rules to obtain the best possible price for their customers, given prevailing market conditions.

When a trade has been completed, either through SOES or telephone contact, the trade information must be transmitted to the clearing corporation for the exchange of money and securities. In SOES transactions, the trade information is automatically transmitted to the clearing corporation. In telephone transactions, each party to the trade submits its trade information to the clearing corporation.

The Options Market

Options are contracts giving the holder the right to buy or sell a stated number of shares of a particular stock at a fixed price within a predetermined time period. Options contracts are not issued by the corporation whose stock underlies the option but, rather, are issued by the Options Clearing Corporation. There are two basic types of options: a "put" is an option to sell, and a "call" is an option to buy. Most options may be exercised by their holder at any time before they expire, or they can be sold to another holder.

Essentially, stock options offer various financial positions that the participants in securities markets may assume besides the typical long-run investment position of buying a security, holding it, and hoping for price appreciation, or selling a security short in anticipation of a decline in price. Speculators can create highly leveraged positions with high potential returns accompanied by substantial risk of loss by using stock options. Alternatively, option strategies involving various combinations of options or combinations of options and stocks can be used by an investor to create a position which has less risk of loss than the usual long or short position.[1]

Until 1973, options were traded only in the over-the-counter (OTC) market. In the early 1930s, a series of congressional and private studies exposed widespread manipulations and fraudulent practices in the securities industry involving the concurrent trading of OTC options and their underlying securities. Consequently, early drafts of the bill that ultimately became the Securities Exchange Act of 1934 would have prohibited the expansion of options trading to national securities exchanges. However, the Congress ultimately allowed exchange options trading but gave the SEC broad discretion to regulate options trading.

Since 1973, the SEC has approved listed options trading programs for several exchanges. As of September 1984, about 380 individual stock options were being traded. In addition, a large number of new options contracts have also been introduced based on U.S. Treasury securities, stock market indexes, and foreign currencies.

Exchange Floor Trading of Options

Options trading on the floors of AMEX and CBOE from the receipt of a customer order through the notification to the customer of an executed trade is similar to stock transactions on the AMEX and NYSE. However, there is one major difference. Options specialists at Amex play the dual role of trading for the public and for their own accounts although some exchange restrictions apply. CBOE does not utilize a specialist system. Instead, CBOE has split up the dealer and agency functions performed by the traditional securities specialist. The dealer function is performed by competing market makers. The broker's broker function is performed by exchange employees called "order book officials." In addition, the CBOE floor has commission and two dollar brokers. Floor brokers execute

[1]It can be difficult to conceptualize the different options positions. For a detailed discussion of option strategies and positions, see "The Different Types of Options," Jack Clark Frances, in Handbook of Financial Markets: Securities, Options, and Futures; edited by Fabozzi and Zarb; Dow Jones-Irwin; 1981.

public orders and may trade for their own account (act as market makers) but not on the same day and in the same option where they have executed public orders.

Clearing Corporations Process the Exchange of Money From Transactions

Five clearing corporations operate for securities and one for options. Of the securities clearing corporations, the National Securities Clearing Corporation (NSCC) is by far the largest and processes approximately 90 percent of all equity transactions on the NYSE, AMEX, and NASDAQ markets. On average, $6 billion worth of securities transactions are settled and cleared daily through NSCC with an average net daily cash settlement of approximately $750 million. Our discussion of the settlement process is thus confined to the NSCC.

Description of the NSCC Settlement Process

The settlement cycle for NSCC is essentially a 5-day period. NSCC interaction with its participants begins on Trade Date +1, the day following trade execution. Buyers and sellers submit trade information either directly to NSCC in New York, to one of NSCC's 12 branch offices across the country, or via direct data transmission. On the night of Trade Date +1, NSCC's comparison systems match related trades by comparing the details of the submission including buyers, sellers, issues, quantities, prices, and markets.

On Trade Date +2, various reports showing trades which successfully matched and transactions which did not match (uncompared trades) are given to the participants. In some instances, the participants' purchase and sale departments attempt to resolve discrepancies. The remaining uncompared trades are returned to brokers and specialists on NYSE and AMEX floors for resolution.

Trade Date +3, the last day to reconcile trades for regular 5-day settlement, begins with the distribution of new reports which recap trades compared the previous day. Reconciliation continues for any unmatched trades.

The principal focus of Trade Date +4 is preparing for settlement at NSCC through Continuous Net Settlement (CNS) or Balance Order processing. CNS nets together each participant's daily transactions in each issue with any previous open positions to create a single long position (securities due to the participant) or a single short position (securities due from the participant). The delivery and receipt of net positions is accomplished by book-entry movements at the Depository Trust Company, where

many stock certificates are stored, rather than by physical delivery. NSCC becomes the opposite party to each participant and guarantees the settlement obligation.

Balance Order processing is used to accommodate those securities in which physical delivery of stock certificates is necessary. Transactions requiring physical delivery are summarized, netted, and allotted between sellers and buyers. Balance Orders, in the form of receive and delivery tickets, are distributed to participants.

Trade Date +5 is settlement day, the day when NSCC facilitates the orderly and controlled exchange of securities and money for all participants. CNS securities obligations are passed through book entry accounts at the Depository Trust Company. Balance Order obligations are settled through participants delivering envelopes containing securities to NSCC where the envelopes are made available to receivers. NSCC credits the deliverer and debits the receiver. Money settlement is the final stage of NSCC's transaction processing. It takes place after NSCC arrives at a single dollar figure due for payment or collection by combining the amounts from CNS and the envelope system. Money is settled with certified checks; electronic funds transfer is not used.

Regulation of the Securities Markets Is a Combination of Self-Regulation With SEC Oversight and Direct Regulation

SROs play an extensive role in industry regulation. These SRO responsibilities include: establishing rules governing conduct and trading; setting qualifications for securities industry professionals; monitoring daily trading activity; examining members for financial health and compliance with rules; investigating alleged violations of securities laws; disciplining violators of SRO or SEC rules and regulations; and responding to inquiries and complaints from investors and members.

SEC provides oversight of SRO regulation by conducting examinations of SROs for compliance with their regulatory responsibilities; maintaining a surveillance capability of its own; and reviewing and approving SRO rules and rule changes. In addition to this oversight, SEC provides direct regulation by conducting investigations, taking disciplinary actions against those beyond SRO authority or against an SRO itself for not doing an adequate regulatory job, and by implementing or changing existing regulations.

The following describes industry regulation by function. For each function, we detail how the SROs accomplish their self-regulatory duties and how SEC oversight is achieved.

SROs Establish Rules of Trading and Conduct Which Must Be Approved by SEC

Through their governing machinery, the exchanges and the NASD impose rules of conduct on themselves as required by the Securities Exchange Act of 1934. The Act mandates that exchange and NASD rules be designed to prevent fraud and manipulation, to foster cooperation and competition in securities trading, to encourage a free and open market, and to protect both investors and the public interest. Because the markets are dynamic, some rules become obsolete, others must be changed to reflect market conditions and practices, and, often, new rules are needed. New rules become effective after both the SRO governing body and the SEC have approved them. The SROs we looked at did not have manuals pertaining to the rulemaking process, so the following description was obtained from the respective SRO officials.

An SRO rule change can be generated as a result of a change in an SEC statute or regulation, a rule change by another SRO, a new product which the SRO desires to market, an SEC recommendation, or a suggestion by SRO personnel or members that a rule is unenforceable, archaic, or not strict enough.

Each new rule submission is prepared by SRO staff who provide it to the appropriate SRO committees for review. The committees—either representing the part of the SRO most affected by the rule change or formed on an ad hoc basis— provide comments on the appropriateness of the rule. Officials at both the SEC and the SROs told us that informal contact between these two groups may be initiated to determine if the rule is acceptable to SEC. This allows the SRO staff to modify problem areas of a prospective rule change prior to formal submission to SEC and, thus, decreases the need for SEC to conduct disapproval hearings. The SRO staff then presents the final version of the rule change to its governing board for approval to file with SEC. SEC reviews the rule change, has it published in the Federal Register to solicit public comment, and will then either approve it, informally request that it be amended, or commence disapproval hearings. At any time during the process, the SRO may withdraw the rule change. During the period from 1980 to 1984, SEC formally disapproved only 3 of 1555 proposed rule changes submitted by the SROs. In cases where a rule is disapproved by SEC, the SRO has the option to seek a remedy in federal court.

MSRB Sets Rules for Municipal Securities

The Congress created the Municipal Securities Rulemaking Board (MSRB) in 1975 responding to the need for more effective policing of that industry. In the late sixties, new issuances of municipal securities

totaled $10 to $11 billion a year. A doubling of volume in the early seventies, coupled with the discovery of fraudulent municipal securities activities in New Jersey, New York, and Tennessee, provided the impetus for congressional action. The legislation creating the MSRB was included in the Securities Acts Amendments of 1975.

According to an MSRB official, the MSRB is a tax exempt, privately funded organization responsible for establishing rules governing municipal securities' broker-dealer activities. The Congress limited MSRB's powers exclusively to rulemaking to avoid duplication of enforcement powers already established under the auspices of the National Association of Securities Dealers (NASD), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (FRB), and the Comptroller of the Currency (OCC). These regulatory agencies review the municipal securities activities of their member firms and banks during routine inspections. They then report these findings to the MSRB. However, each has the authority to impose disciplinary sanctions for violations of MSRB rules. The MSRB does not have such authority.

Rulemaking guidelines established by MSRB, intended to create uniform practices, go through the same approval/ disapproval process at the SEC as described above for the other SROs. MSRB's rulemaking authority extends to the following areas:

- standards of professional qualification;
- rules of fair practice;
- recordkeeping;
- scope and frequency of compliance examinations performed by OCC, NASD, FRB, and FDIC;
- nature of security quotations; and
- sale of new issue municipal securities.

The MSRB Board is comprised of 15 members—5 bank dealer representatives, 5 securities representatives, and 5 public sector members—where one of the public members is representative of issuers of municipal securities while another is representative of investors. Members are selected for staggered 3-year terms as five members rotate off the Board annually. The Board meets 5 times a year for 3-day sessions.

The MSRB has a professional staff who serve the Board in the development of rules. Complementing the Board and professional staff are

standing committees on arbitration, oversight and compliance, interpretations, finance and personnel, professional qualifications, and research and planning.

The actual rulemaking process relies heavily on member and nonmember input. Once the Board has decided to pursue a rule enactment or alteration, it sends the draft out to those on its mailing list for comment. If negative feedback is received, the MSRB may drop the rule entirely or rework its contents. With favorable feedback, the Board forwards the rule to SEC generally seeking informal SEC review before formally filing a proposed rule change. Once formally filed, the SEC publishes the rule change in the Federal Register and can then either approve it, informally request changes to the rule, or start disapproval proceedings. Although SEC can formally disapprove a rule, the two organizations have always been able to work out their differences and no formal SEC disapprovals have occurred. Generally, 18 to 20 rules are submitted annually by MSRB.

An MSRB official told us the Board must serve and protect two publics. Rules are generated to protect the investing public. However, protection of the investing public cannot be made without consideration for an issuer's ability to generate revenue for the implementation of projects servicing a given jurisdiction (i.e. parks, roads, sewage). There must be a balance between protecting investors and allowing for the generation of capital to finance projects that serve the public good.

Firms and Individuals Conducting a Securities Business Must Be Properly Registered

The Securities Exchange Act of 1934 requires securities broker-dealers to be registered with the SEC. However, firms dealing exclusively in exempted securities, commercial paper, bankers' acceptances, and commercial bills need not register. Additionally, a broker or dealer whose business is exclusively intrastate and who does not use any facility of a national securities exchange is not required to register.

The registration process is commenced when the broker-dealer submits a completed application form and statement of financial condition with the SEC. The form essentially requires the following information: (1) what the firm's business will be, (2) whether the applicant has ever been disciplined by the SEC, CFTC, state, or SRO (and supporting details), (3) whether the party has committed a felony or misdemeanor (primarily relating to funds/securities), and (4) who the principals of the firm will be (owners, higher level officers). There is no fee for filing. The application can be returned to the applicant by SEC if all items have not

been completed as required, or if it is otherwise considered unacceptable.

We were advised that, in addition to registering with the SEC, a broker-dealer is required to become a member of the appropriate SRO. If a broker-dealer conducts business solely with a national securities exchange of which it is a member, then that exchange is the appropriate SRO. If the broker-dealer transacts business in the over-the-counter market, it must become a member of a national securities association. Since NASD is the only such association, membership with NASD is mandatory for broker-dealers trading in the over-the-counter market. A broker-dealer that effects transactions both with an exchange and the over-the-counter market must become a member of both the exchange and the NASD. (A limited exemption from the requirement to join a national securities association exists for broker-dealers that belong to an exchange, carry no customer accounts, and derive gross income from securities transactions on that exchange of less than $1000.) Within 45 days of registration being granted, every broker-dealer that does an over-the-counter business (except those exempt as mentioned above) must apply for membership with NASD. Additionally, every registered broker-dealer must be a member of the Securities Investor Protection Corporation unless its principal business is conducted outside the United States or consists exclusively of the sale or distribution of investment company shares, variable annuities, or insurance.

As a general rule, SEC does not deny applications for registration as a broker-dealer. We were told that, if an application appears to be one with potential for being turned down, SEC contacts the entity for clarification and additional information. Many times, as a result of these inquiries, applications are withdrawn. Therefore, those applications that would probably be denied rarely stay in the system long enough for this to happen.

Also, we were told by SEC staff that "associated person(s)" of a broker-dealer must also be registered with the appropriate SRO. Associated persons include any partner, officer, director, branch manager, controlling or controlled person, or employee of a broker-dealer. Every associated person, other than one whose functions are solely clerical or administrative, must meet certain specified qualification requirements. These qualifications include passing a general securities examination and having his/her employer file an application with the applicable exchange and NASD. The test is a standardized one given by the NASD and covers the fundamentals of how the markets work. The registration form also

requests information about the individual's prior employment and disciplinary history.

Associated persons must also provide fingerprints to the SRO which are then submitted to the FBI for a criminal record check. Exempt from this are those persons who do not sell securities; do not have access to securities, money, or original books and records; and do not supervise persons engaged in such activities.

Securities Transactions Are Monitored Daily by SROs, and Periodically Examined by the SEC, to Detect and Deter Illegal Trading Activities

As part of the self-regulatory function, the exchanges and NASD maintain various surveillance systems which monitor trading of stocks and options. While specific variables analyzed in these systems differ (i.e., price, volume, traders, and time frame covered), the overall structure among the SROs is consistent. When these surveillance systems detect unusual stock price or volume movement, or trader activity, an SRO analyst initiates followup procedures until the problem is adequately explained. Should the surveillance staff at an SRO determine that an investigation is warranted, it refers the information to the appropriate investigative or enforcement arm of the SRO or to the SEC, depending on jurisdiction.

SEC maintains a surveillance capability and periodically conducts its own surveillance to determine if the SROs are doing an adequate job of detecting illegal trades.

SROs Have Various Surveillance Systems Designed to Detect Illegal Trading Practices

Many surveillance systems using different criteria are in place at the SROs to detect illegal trading. Some examples of illegal trades are:

- insider trading - where traders have access to corporate information not publicly available enabling them to make transactions that yield a profit when the information is disseminated;
- manipulation - where securities transactions are effected specifically to raise or depress prices; and,
- specialists trading ahead of the public - where specialists execute trades for themselves before executing public orders at the same price.

Other forms of illegal trading include wash trades, frontrunning, mini-manipulation, capping, and pegging; they are defined in the glossary of this report.

The particular mechanisms used to highlight questionable trading activity have various components relating to the type of illegal trading activity each mechanism is trying to detect. One of these mechanisms targets unusual price and/or volume activity as a means to alert analysts to possible insider trading or manipulation violations. This is accomplished by having computer programs written which summarize previous price and volume activity of stocks and determine what the normal variations have been. With this information, a set of parameters is established within which trading is considered to be normal. SROs set their own parameters either for each security, or for all securities within a specific price range. When trading activity causes a security to be traded at a price or volume outside the established parameters, the surveillance analysts are alerted and undertake efforts to explain this activity.

Exchanges perform additional surveillance by reviewing floor trading activity. For example, analysts may employ automated surveillance systems to reconstruct trading to determine both the sequence of transactions and the participants involved to identify possible trading rule violations. Through such techniques, exchanges can determine, for example, if specialists are honoring their responsibilities to maintain fair and orderly markets and not to trade for themselves ahead of customers.

In addition, each specialist is subject to a full audit of all transactions over specific periods of time. The time periods selected are unknown to the specialist until the audit is initiated. This allows the SRO to see if all trades are being executed by the specialist at the best price available, as well as in accordance with all other exchange rules.

According to NASD officials, NASD surveillance of the NASDAQ market provides for on-line automated review of changes of bids and offers and of last-sale and volume reports. Unusual trading activity triggers one or more parameter break alerts. This system gives NASD analysts the ability to reconstruct unusual trading patterns and to create an audit trail of quotation and trading activity for all market makers. In addition, the NASD conducts unannounced, on-site member inspections, which reinforce and supplement the work of its market surveillance section.

Finally, other reports reviewed by SRO staff include weekly and monthly summations of trading activity, daily summations of all block trading (10,000 or more shares), and numerous other reports. All surveillance

systems combined allow the SROs to track trades from minutes after execution to months and years after their completion.

Suspicious Transactions Are Pursued by SRO Staff

Abnormal trading phenomena detected by surveillance staff are followed up on for explanation. Much of the suspicious trading is easily explained, such as heavy trading in a security following a major press release concerning a takeover, merger, or financial report. Generally, these followup procedures are similar among the SROs. Some of these steps include: reviewing current press releases; reviewing historical trading activity in the stock; interviewing brokers, specialists, market makers, and issuer company officials; and, sending a questionnaire to both the issuer and brokerage firm involved. These procedures are usually done in the sequence above until the trade is adequately explained.

If the followup procedures are exhausted and the analyst is not satisfied, or if the analyst believes that SEC or SRO rules have been violated, then a referral is made to the enforcement arm of the SRO or to the SEC, depending on jurisdiction.

Intermarket Surveillance Group Coordinates Surveillance Activities Among the SROs

The Intermarket Surveillance Group (ISG) was initially formed in early 1981 to coordinate industrywide exchange of surveillance data with a particular emphasis on assuring the integrity of options and equities trading. The ISG is comprised of senior surveillance and enforcement representatives of the following SROs: AMEX, Boston Stock Exchange, CBOE, Cincinnati Stock Exchange, Midwest Stock Exchange, NASD, NYSE, Pacific Stock Exchange, and the Philadelphia Stock Exchange. Also, the Chicago Mercantile Exchange, the Chicago Board of Trade, and the New York Futures Exchange are participants in a sub-committee of the ISG concerning the surveillance of stock-index products. Each SRO has designated contact points for intermarket matters.

To improve intermarket surveillance among the SROs, the ISG identified and described intermarket trading activities requiring improved SRO surveillance information, identified all sources of intermarket trading surveillance information, developed minimum surveillance procedures needed at each SRO to detect improper trading activity and established communication and coordination procedures for the surveillance, investigation, and prosecution of intermarket violations.

When preliminary analysis of trading data by an SRO indicates a potential intermarket violation, the detecting SRO contacts other interested

SROs. A coordinating SRO is designated to coordinate the collection and analysis of information related to the investigation and to communicate as appropriate with the SEC and all interested SROs. When intermarket violations are found, agreement is reached regarding which SRO(s) will bring disciplinary actions. Through September 1983, more than 267 instances of possible intermarket violations have been identified and investigated by the participating SROs.

The ISG developed a system of case logs which provide for the reporting of the progress and disposition of all intermarket investigations. The case logs are updated and circulated monthly to all SROs. The ISG submits to SEC a monthly log describing intermarket investigations opened and closed and the coordinating SRO will provide any other reports requested by SEC for a particular investigation.

SEC's Surveillance Capability Is Used Principally for SRO Oversight

Surveillance of trading on the stock and options markets conducted by SEC is designed for three purposes: (1) SRO oversight; (2) experimentation with new surveillance methods for SRO use; and, (3) a data source for SEC inspections and investigations. The market information data system, which replaced the Market Oversight Surveillance System (MOSS) in December 1984, is the computer system enabling SEC to conduct surveillance.

According to an SEC official, SEC surveillance is predicated on the assessment that SRO surveillance mechanisms are generally effective. Although it has the capacity, SEC does not do on-line surveillance of daily market activity. However, the SROs are required to submit daily trade data to SEC which is stored on its surveillance data base. At unspecified time intervals, SEC runs a month of this trade data through a computer system which, like the SROs, has pre-established parameters, based on mathematical formulas, beyond which trades are noted as suspicious. Several of these programs exist, each of which denotes specific types of suspicious trades. The SEC's Division of Market Regulation then requests the SRO to supply all investigations for the corresponding month of trade data. A comparison between the SRO findings and the SEC findings is made to determine the number of suspicious trades overlooked by the SRO surveillance system. If SEC determines that the SRO did not adequately detect those trades failing the SEC test, the SEC could suggest that the SRO change its computer surveillance formula.

SEC experiments with its surveillance computer programs to develop better systems to detect illegal trades. If SEC develops a better program,

it will suggest that the SRO consider such a system. By relying on the SROs for daily surveillance, SEC does not need on-line surveillance staff.

A further use of the SEC surveillance system is as a data source for both the inspections staff in SEC's Division of Market Regulation and investigators in the Enforcement Division investigations, SEC officials told us. The data on this system provides information on broker-dealers and exchanges which can highlight areas for special attention during an examination and can be a source of evidence during Enforcement's investigations.

SROs Examine Members to Assure Compliance With Their Rules and Federal Securities Laws, and SEC Monitors This Compliance by Inspecting the SROs

SROs conduct financial examinations and sales practice inspections of its member firms. Financial examinations strive to assure that members and member firms comply with SRO and SEC requirements and operate in sound financial and operational condition. Sales practice inspections seek to assure member compliance with SEC and SRO sales practice rules and supervisory procedures. If a firm belongs to more than one self-regulatory organization, the SEC designates one as the principal examining authority responsible for determining the firm's compliance with the financial responsibility requirements under federal securities laws.

In its oversight role, SEC inspects the SROs to determine if their examination and surveillance methods are adequate to detect illegal activities of members.

SRO Examinations Are Conducted on a Routine Basis

Examinations of the financial health and practices of members, and the sales methods employed, are carried out by the SROs on an annual basis. The procedures for conducting these exams vary among the SROs and are dealt with in general terms here. Typically, the SROs conduct unannounced examinations.

SRO financial exams can include a review of the firm's books, records, and margin requirements, verification of information submitted to the SRO in financial reports, and a review of compliance with SEC and SRO net capital rules. The net capital rule measures the liquidity of broker-dealer firms.

Financial examiners have also delved into such matters as the firm's organizational structure, internal controls, insurance coverage, and customer accounts. The exam's scope depends on the type of member activity being reviewed. SRO surveillance reports, customer complaints,

and previous SRO exams are consulted by examiners before entering the firm as a means to highlight those activities requiring special attention.

Sales practice examinations are carried out in much the same way as financial inspections but with different aspects of a firm's operations explored. Here, the SRO examiners look for such things as account churning[2] and unauthorized trading done by employees, unsuitable customer transactions, conversions of customer funds for the firm's or employee's personal use, and accuracy in the firm's advertising. Some of the items examined to determine compliance in the area are procedures used in opening customer accounts, filing of reports, confirmation of trades and monthly statements sent to customers, supervision exercised over accounts, customer complaints, and advertising material used by the firm.

Upon completion of an inspection, the SRO examination staff holds an exit interview with the firm. At this point, the firm is advised of any problems or violations that have been detected. When violations are noted, the staff classifies the severity of the violation. Criteria for these classifications differ among the SROs, but some generalizations can be made. A minor violation might include a firm making a first time, unintentional error in its recordkeeping or calculations but where customer funds were not in jeopardy or the firm's actual financial condition met the regulations. Major violations include intentional misuse of customer funds, repeat errors in bookkeeping, fraud, and any mistake which puts customer funds in jeopardy.

When the firm is advised of possible violations, it must give assurances that the problem will be corrected or provide an explanation as to why it believes the practices are not violative of applicable rules or regulations. A firm may be required to submit, in writing, the steps taken to avoid the problem in the future. This does not preclude the SRO from putting the firm on an internal alert list, referring the matter to its enforcement section for a full scale investigation, or taking disciplinary actions. In some cases, SROs conduct followup, special exams to be sure that violations have been dealt with and rectified.

SROs submit reports to SEC on a routine basis (i.e., monthly, semi-monthly), which detail all ongoing and completed examinations and the problems identified.

[2]Excessive trading in a customer's account done purely to increase a broker's commissions.

SEC Conducts Inspections of SROs to Assure Compliance With Laws and Adequacy of SRO Examination Procedures

SEC's inspections of SROs consist of surveillance inspections and broker-dealer inspections. Surveillance inspections concentrate strictly on market trading activity and the ability of SROs to monitor these functions. Inspections are generally conducted by two to five people from SEC headquarters who spend 1 week to 2 months preparing for an inspection and 1 or more weeks examining the SRO in question. A written report on their findings is then produced.

SEC attempts to inspect each SRO once every 2 years. Larger SROs are inspected more frequently due to the higher level of volume, and inspections can also be initiated when a specific problem arises. SROs are notified in writing 2 weeks before an inspection to advise them of its nature and scope. This notice also allows the SROs to gather cases illustrating techniques used in detecting a certain violation, to organize files by type of violation, and to have surveillance data handy.

In preparing for inspections, SEC utilizes its market information data system for information. This system can detect deficiencies in SRO surveillance systems. The inspection team also compares data stored in the system to data found at the SROs to detect inconsistencies. Therefore, the system is used both as a planning tool for investigations and an evaluation mechanism for information gathered. On-site inspection consists of questioning SRO staff, reviewing files, and documenting surveillance cycles for each violation under review. SEC, upon completion of the on-site inspection, reviews materials collected for thoroughness of initial inquiries relating to violations, adequacy of follow through efforts, and disciplinary actions taken, if necessary. An exit meeting is usually conducted to provide the SRO with a preliminary overview of the report findings.

When the report is completed, it is forwarded to the Commission and a letter is produced encompassing the findings of the report for submission to the involved SRO. The SRO comments on the report in a response letter, which includes its reaction to SEC findings. However, it is rare for SEC to change its findings.

Broker-dealer inspections review financial operations, recordkeeping, and sales practices. These inspections are conducted to ensure that SROs are effectively examining their broker-dealer members and taking prompt and appropriate action when apparent violations are found. To achieve this, broker-dealer inspections consist of both a review of SRO-performed broker-dealer exams and a comparison between these SRO

exams and SEC performed broker-dealer audits. Broker-dealer inspections are geared to assess SRO performance in policing member firms regarding financial operations and sales practices.

Two types of broker-dealer exams are performed. The first is a routine oversight exam. Generally, 5 to 8 percent of broker-dealer firms are audited through a sampling technique each year. There are approximately 8,000 broker-dealers, compared to 100 SEC examiners, which is why such a small percentage get audited annually. Results of the oversight exam are compared to findings from the SRO audit. In comparing its findings with SRO audits, SEC determines how effectively the SRO is performing its policing responsibilities. As part of the broker-dealer inspection, SEC reviews financial responsibility rules. SEC sets minimum financial rules for the SROs unless the SRO has a stronger rule already in place. Two of the financial responsibility rules are the net capital rule and the segregation rule. The net capital rule is the means by which SEC tests the liquidity of broker-dealer firms. There are two tests employed. The first deals with indebtedness as a ratio to net capital while the second test sets minimum levels of net capital acceptable in relationship to broker-dealer receivables. Segregation is designed to keep customer's funds and fully paid securities separate from the firm's operating funds or other assets.

The second type of broker-dealer inspection is a cause exam which can be generated from specific referrals about a firm through customer complaints, market trends, recommendations by an SRO, situations in which the SEC considers a broker-dealer to be in financial difficulty, or for other reasons where the SEC deems an inspection is necessary. In performing these reviews, SEC makes unannounced visits to negate the possibility of a broker-dealer tampering with records before SEC's arrival.

SROs and SEC Investigate Alleged Violations of Securities Laws and Take Disciplinary Actions

SROs are required to enforce member compliance with SRO rules as well as federal securities laws. To accomplish this duty, each of the exchanges reviewed and the NASD has staff devoted to investigations of alleged violations of these rules and laws. In addition, SROs conduct disciplinary hearings and penalize their members when violations are found. However, SROs have no authority to issue investigative subpoenas or discipline nonmembers. When such subpoenas are necessary or when nonmembers are suspect, the SROs refer the investigation to the SEC Enforcement Division.

Investigations are undertaken at SEC both independently and by referral from SROs or other sources. When these investigations expose probable violations of securities laws, SEC pursues disciplinary actions either through its administrative law process, in U.S. District Court, or both.

SRO Investigations: Formation and Process

Investigations by SROs can be initiated based on information received from any of a number of sources. Some of these sources include SRO market surveillance or examination staff, complaints from investors or members, and referrals from other SROs and the SEC.

Exchange staff obtain and develop facts regarding the alleged violations. If no violation occurred, the case is not pursued. If a violation is believed to have occurred, the exchange staff will initiate a disciplinary action. At the NASD, enforcement of rules rests primarily with its 13 District Business Conduct Committees, which would initiate a disciplinary action on facts developed by the NASD staff.

The procedures for hearings stemming from disciplinary actions are outlined in SRO rules and relate to notice, opportunity to defend, record-keeping, and statements of reasons for sanctions. When SRO staff determine that a member may have violated a rule, the SRO notifies the member of charges against it and schedules a disciplinary hearing. During the hearing, the SRO and the alleged violator(s) or their attorneys present the facts to the SRO's hearing panel. After analyzing the facts, the committee decides if a violation occurred and, if so, what the penalty should be.

Some examples of actions or penalties imposed by the SROs include:

- Warning letters - These notify the violator that repetition of the same conduct could lead to further disciplinary action. According to SRO officials, letters are issued for minor violations and are informal.
- Fines - Individual violators are assessed fines that range up to $25,000 for each violation. Member firms may be fined up to $100,000 for each violation.
- Suspension - Suspended members are denied access to their market's trading facilities, prevented from dealing with other members, or not allowed to trade as members for a specified period of time. Suspensions can also apply to employees of member firms.
- Expulsion - Members expelled from the exchange or NASD are prevented from trading on the exchange floor or trading with other NASD members

and lose their membership. Employees of member firms may also be prevented from working in the industry.

However, the committee decision is subject to appeal to the SRO's governing board. In addition, Board decisions can be further appealed to the SEC, and subsequently to the U.S. Court of Appeals.

SROs are required to give SEC notice of final formal disciplinary actions, which are subject to review by the SEC on its own volition or upon application by the aggrieved person. The SEC may set aside the sanction or it may reduce (but not increase) the penalty. An aggrieved person may appeal the Commission's decision directly to the U.S. Court of Appeals.

SRO rules also permit resolution of cases by settlement. In a settlement, a member charged with a violation can resolve the charge without a contested hearing. The member's and the SRO's attorneys meet and agree on a penalty for the violation committed. In a settlement, the violator agrees to the penalty but neither admits nor denies guilt. Settlements are subject to SRO panel review and approval. The panel can accept the settlement terms, reduce the penalty, or reject the penalty, for example, on the grounds that it is too lenient.

SEC Conducts Investigations of Individuals, Firms, and the SROs Themselves and Seeks Disciplinary Actions Where Appropriate

Enforcement at SEC is its largest single activity. Division of Enforcement activities are approximately one-third of the total SEC budget. The enforcement activities described below were explained to us by SEC Enforcement Division officials.

The SEC Enforcement staff gathers information from any credible source. Last year, sources of SEC Enforcement actions included customer complaints, SEC oversight examinations, informants, news media, the SROs themselves, SEC market surveillance, state and local government agencies, other federal agencies, other SEC Divisions, and issuer filings with SEC.

The SEC Enforcement Division conducts many types of investigations. One example of these is a trading investigation which often begins with SROs informing the Enforcement Division that unusual trading activity is occurring. This contact is informal, usually through a telephone call. Enforcement works closely with the SRO to investigate the matter and get explanations from the trading parties involved. If the SRO receives an unsatisfactory explanation, if it is denied an explanation, or if the parties involved are beyond SRO jurisdiction, SEC may pursue the matter.

However, SEC officials told us, the SROs can handle most of the problems identified by their market surveillance staff.

When SEC responds to the problem, it reviews the microfiche records of every cleared trade at the SRO. This data contains information on the broker who made the trade and the security, quantity, and price of the transaction. SEC can require the broker to supply the customer's name and address. This information is compared to records maintained by SEC and from this it can be determined if the individual has come under investigation previously.

SEC may contact the individuals or firms in question and request an explanation of the questionable trades or trading practices. If plausible explanations are forthcoming, and there is no other reason to continue the inquiry, Enforcement closes the inquiry. If a full investigation is warranted, Enforcement proceeds with either an informal inquiry or requests a formal order of investigation from the SEC Commissioners. An informal inquiry does not convey subpoena power to the Enforcement Division. A formal order of investigation delegates SEC subpoena power to the Enforcement Division and requires Commission approval.

As investigations progress, the Enforcement staff evaluates whether sanctions should be sought. If it concludes sanctions are unnecessary, the case is closed. If the staff believes sanctions are appropriate, the staff sends a memorandum to the Commission recommending an action. At this point, potential defendants or respondents may submit their written version of the facts to Enforcement. This is called a "Wells submission." The Enforcement staff forwards its recommendation and the Wells submission jointly to the Commissioners for their review. The Commissioners review the findings of the Enforcement staff, the Wells submission explanations of the party being investigated, and any other information deemed pertinent. The Commissioners then determine whether to issue the charges, amend the charges, or reject Enforcement's recommendation.

Most enforcement actions taken by the SEC are resolved through settlement rather than litigation. Settlements are an agreement between Enforcement and the defendants in which the defendant typically accepts the penalty without admitting or denying guilt. Through settlement, both parties are saved the expense and time of adjudication. The Commissioners must approve settlement terms in administrative proceedings and, for civil proceedings, the Commissioners authorize settlement terms to be presented to the courts.

Sanctions sought by the SEC are either administrative or civil, or both. Administrative Law Judges within SEC preside over contested administrative proceedings while civil matters are heard in U.S. District Court. Administrative sanctions sought include suspension, revocation, or limitation of a broker-dealer registration, and can be imposed on individuals associated with broker-dealer firms as well. Civil penalties consist of injunctions and ancillary relief such as freezing of assets, disgorgement of illegal profits, and restitution to investors. SEC refers criminal allegations to the U.S. Department of Justice for its review and possible prosecution and, in some instances, SEC assists the U.S. Attorney with the investigation.

Appeals of administrative sanctions are heard before the SEC Commissioners. These appeals can be based on the facts of the case, the law in question, or the penalty assessed. Any further appeal would be to the U.S. Court of Appeals. Civil actions are filed in U.S. District Court and are beyond the jurisdiction of SEC to overturn; appeals of these decisions must be filed in the U.S. Court of Appeals.

NSCC Surveillance/ Disciplinary Actions

The National Securities Clearing Corporation's Membership and Compliance Department is responsible for minimizing risks to NSCC which might arise from a participant's failure to fulfill its obligations to NSCC. NSCC performs regular surveillance of participants by reviewing computerized reports of trades, financial reports from participants, and news reports, as well as by maintaining formal and informal contact with the other SROs. One report used by NSCC in its surveillance efforts is the "concentration report" which identifies participants with significant concentrations of unsettled transactions in the Continuous Net Settlement System after settlement day. The surveillance procedures are designed to detect participants with financial or operational problems, unusual clearing activity, and other developments which might have an adverse effect on the participants.

The NYSE, AMEX, and NASD have formally agreed to provide regulatory services to the NSCC, which include periodic examinations of the records and operations of participants, the monitoring and investigation of the financial and operating condition of participants and new applicants for membership, and notification to the NSCC of unusual market conditions which may affect the NSCC or its membership. NSCC generally relies on the SROs to do financial examinations although NSCC does occasionally perform operational reviews of participants.

If the NSCC staff becomes concerned about a participant's financial or operating condition, it will monitor the participant more closely. If a firm's condition worsens, it may be placed on the official daily surveillance list. For all firms on the list, clearing and settlement activity is monitored daily and the clearing fund requirement is calculated daily. NSCC may request additional clearing fund deposits in these instances and can also request that the responsible SRO conduct an examination of the participant.

Sanctions available to NSCC include suspension of a participant or fines. In less serious matters, NSCC may verbally admonish the firm or send a formal letter to the firm's management. NSCC can suspend a participant if it fails to make a clearing fund deposit, fails to meet settlement, or is suspended by another SRO.

SEC Oversight of Clearing Corporations

The 1934 Securities Exchange Act and the SEC categorize clearing corporations as SROs, and the SEC maintains oversight in three ways: inspections, mandatory independent financial audits, and rule approval.

Inspections of clearing agencies are done infrequently and on an irregular basis, generally when the need arises. The largest clearing corporation, NSCC, which, according to an NSCC official, clears approximately 80 percent of all equity securities transactions, has undergone two SEC oversight inspections, both in 1983. An SEC official told us there is less of a need to inspect clearing corporations than other SROs for several reasons. First, unlike the exchanges and NASD, clearing corporations generally do not have to consider subjective rules such as those dealing with ethical behavior of members, fair trading, or manipulation. Rather, clearing corporation rules are concerned primarily with credit worthiness of members who are monitored closely to reduce credit risk, which is one of the clearing corporations' major goals. Second, this close monitoring of member credit risk serves the SEC's objectives at the same time as it enhances the smooth functioning of the clearing process. Officials at both NSCC and SEC told us that clearing agencies protect their own financial interests when the rules are followed. A third reason is that each clearing corporation is required to have an annual independent financial audit which must be submitted to SEC. According to an SEC inspection official, these audit results contain a substantial amount of information SEC needs to carry out its oversight function.

The final aspect of SEC oversight of clearing corporations is the rule approval process. As with the exchanges and the NASD, all new rules and rule changes must be approved by SEC prior to enactment.

SROs Have Procedures to Resolve Customer Complaints and SEC Forwards Complaints It Receives to Either the Broker-Dealer or the SRO

The SROs have arbitration procedures available to those seeking monetary settlement. Arbitration is a less costly and quicker method to resolve complaints than its alternative—civil court litigation.

SEC has no administrative procedures for the hearing and settling of customer complaints, although it receives thousands every year. SEC acts as a conduit for information in that it forwards complaints to either the firm alleged to have done a misdeed, or to the member firm's SRO, for action. However, if SEC receives many complaints about similar activities, it may use the information to either open an investigation or target a specific activity for special review during a normal inspection.

SROs Have Various Complaint Handling Procedures

The SROs deal with complaints in different ways depending on the type of complaint received. Sources for complaints include the public, listed companies, SRO members, the SEC, and other SROs. Different procedures are followed by the various SROs in their handling of customer complaints. For those complaints against a brokerage firm, the exchange initially refers the matter to that firm for it to resolve. However, the exchange generally follows up to see that the complaint is satisfied and may also inform the complainant of arbitration procedures available if satisfaction is not attained. In addition, even if the complaint is satisfied, the exchange may initiate its own investigation and take disciplinary action if rule violations occurred.

Complaints which allege improper floor activity are investigated by the exchange itself. Regardless of the type of complaint received, the exchange may refer the matter to its enforcement arm for investigation, and disciplinary action may be taken.

According to NASD officials, they investigate each customer complaint received. In following up on these complaints, NASD exchanges correspondence with the customer and firm and may interview the customer and appropriate personnel at the firm. If necessary, NASD may conduct an on-site examination to develop the facts. As with the exchanges, the NASD may initiate an investigation and take disciplinary action if rule violations are found, irrespective of whether arbitration is pursued by the complainant.

SEC Refers Complaints to SROs and Member Firms

The SEC Office of Consumer Affairs and Information Services (CAIS) handles investor inquiries and complaints. SEC received over 30,000 inquiries and complaints in fiscal year 1984. Of these, 48 percent involved investor conflicts with registered broker-dealers, 30 percent concerned issuers of securities, and 4 percent pertained to mutual funds.

According to CAIS officials, CAIS's role is to assist both the investor and the SEC, by helping the investor solve his/her concerns, and by helping SEC look for patterns of misconduct. However, CAIS does not get involved in the resolution of complaints from the public, functioning more as a conduit for information. When an investor submits a complaint to SEC, the CAIS staff contacts the entity involved, sends it a copy of the complaint, and asks that an explanation be given. Complaints are often resolved by getting the parties talking and by putting the issues down on paper. If the parties involved cannot resolve their differences, the CAIS staff informs the investor of binding arbitration programs sponsored by the SROs and, if appropriate, provides a copy of the complaint to an SEC regional office.

The CAIS staff added that it keeps a record of the complaints filed by the entity involved. Although the CAIS staff does not follow up on what happens to a complaint after it is referred to the SRO, the SEC regional office where it has been referred follows up. If a pattern begins to develop, such as a particular firm having a number of similar complaints filed against it, the CAIS staff would refer the information to another group within SEC for investigation purposes. This could be the Division of Enforcement for egregious cases of misconduct or the Division of Market Regulation for those cases in which an SRO might not be disciplining its members in an appropriate manner.

The investor, thus, has two options for resolving the dispute—arbitration and litigation, both of which can be pursued by the investor.

Arbitration Procedures Available to Resolve Complaints Seeking Monetary Recovery

The Uniform Code of Arbitration, adopted by the SROs between 1979 and 1980, is an expedited means of handling disputes. If the investor chooses this means for resolving a dispute, the business entity involved is obligated to accept the choice.

The arbitration process begins with the investor filing a complaint with the SRO. Arbitration cases fall into two categories, based on the dollar amount of the dispute—up to $5,000 and above $5,000. The filing fee for those claims of $5,000 or less ranges from $15 to $100 depending on

the exact amount of the claim, and there is a sliding scale, based on the disputed amount, for cases over $5,000. The SRO then appoints an arbitrator(s) from a pool of names to review the case. The individuals in the pool often have had professional experience in the securities field. However, the majority of the members of such arbitration panels have no connection with a broker-dealer or securities industry organization at the time they serve. One arbitrator is chosen for complaints of $5,000 or less, three to five are selected for those complaints over $5,000 and up to $100,000, and five arbitrators hear complaints involving more than $100,000.

For those disputes of $5,000 or less, a hearing is not necessary and is only held at the desire of the investor or the arbitrator. If the complaint is for more than $5,000, a hearing is routinely held unless the parties agree to waive this right. If a hearing is not held, the matter will be decided based only on the documents filed. The remedies awarded in arbitration are primarily money and are binding. Under the Federal Arbitration Act, a claimant dissatisfied with a decision can seek review in federal court to have the award vacated or modified. However, notice of a motion to vacate or modify an award must be served upon the adverse party or their attorney within 3 months after the award is filed or delivered. The grounds for vacating an award are quite limited and relate generally to the integrity of the arbitration proceeding. Other limited circumstances, such as material miscalculation of the figures underlying an award, can result in the modification of an award at the request of one of the parties. This change, however, does not constitute a retrial based on the case's merits.

The investor can also choose to pursue private litigation to recover damages from parties who have violated the law. This is done through the federal or state court system.

SIPC Protects Investors From Nonmarket Related Losses

The Securities Investor Protection Corporation (SIPC) was created by the Congress in 1970 as a non-profit membership corporation with the passage of the Securities Investor Protection Act. It was established to protect customer deposits and security holdings against broker-dealer insolvency. Currently, each customer has protection of $500,000 of which no more than $100,000 can be for a claim for cash, as opposed to securities. The SIPC staff initiates steps to liquidate a failed member firm, reviews claims by customers of a failed firm, and reviews distributions of property.

SIPC's Board of Directors is comprised of seven people. Five are Presidential appointees (three from the securities industry, two from the general public) one Treasury Department official appointed by the Secretary of the Treasury, and one Federal Reserve official appointed by the Federal Reserve Board.

Funding for SIPC comes exclusively from its membership, all of whom are members of the various SROs. Members are currently assessed 1/4 of 1 percent of their gross securities revenues. Assessments to member firms vary according to the level of revenue necessary to maintain the SIPC fund. When the corporation was initially set up in 1970, the members were assessed a fee of 1/2 of 1 percent of gross revenue from their securities business. In 1978, the fund exceeded its minimum target of $150 million. Since the fund had reached this level, the assessment rate was lowered to 1/4 of 1 percent for a 6-month period, then to $25 per year to maintain membership and assessment records.

Between 1981 and 1983, three liquidations caused $82 million to be advanced to trustees for customer accounts. (Trustees pay customers promptly to avoid making them wait for legal proceedings [where applicable] to conclude.) Based on this $82 million payout, SIPC reassessed at a rate of 1/4 of 1 percent to build the fund to $300 million. When this target is reached, member assessments will be reduced accordingly. Should a financial emergency arise that depletes the fund, SIPC has the power to borrow up to $1 billion from the U.S. Treasury, through the SEC. As of December 31, 1985, SIPC has commenced 189 customer protection proceedings.

With some exceptions, all persons registered as broker-dealers under Section 15(b) of the 1934 Securities Exchange Act and all persons that are members of the NASD or a national securities exchange are members of SIPC. Exceptions include broker-dealers dealing only in mutual funds, variable annuities, insurance, or investment advice to insurance company separate accounts.

According to a SIPC official, SIPC works with the SEC in two ways. First, SIPC must send all by-law and rule changes to SEC for its approval. By-law changes can be enacted if the SEC does not disapprove. However, in the case of a rule change, the SEC must formally approve the change before it can be enacted. If SEC has objections to a proposed rule change, an informal dialogue with SIPC is initiated until the change is amenable to SEC. Second, SIPC receives information from SEC (and the SROs as well) on all broker-dealers experiencing financial difficulties. SIPC relies

entirely on SEC and the SROs for this information as it has no investigative authority. From the results of SEC and SRO investigations, SIPC determines whether to file in U.S. District Court for liquidation of a broker-dealer.

Historical Development of Futures Markets and the Legal Framework of Self-Regulation

The current regulatory framework which governs the futures industry grew out of the Congress' belief, as outlined in the Commodity Exchange Act, that federal regulation was essential because

- transactions in futures are carried on in large volume;
- futures transactions are susceptible to manipulation and excessive speculation which could cause volatile price fluctuations; and
- unreasonable price fluctuations injure both producers and consumers and are a burden on interstate commerce, making the regulation of the futures industry in the public interest.

The fundamental purpose of federal regulation is to ensure fair and orderly markets, thus providing a measure of control over possible manipulative activities and speculative excesses that could injure agricultural producers, other customers that use the markets, and the futures markets themselves. As in the securities industry, the regulation of futures markets is based on industry self-regulation with federal government oversight.

Economic Functions of Futures Markets

Although the futures markets originally developed to better manage risks in the agricultural sector, today these markets offer nonagricultural products as well including futures on metals, petroleum products, and financial instruments. The futures markets offer investors opportunities to better manage their financial risks through price discovery and risk shifting.

The competitive process through which traders buy and sell futures contracts on the exchange floor allows them to "discover" the prices that best represent the consensus of what traders think commodity prices ought to be in the future based on information available today. Broad dissemination and publication of exchange-generated prices foster competition.

Risk shifting is the method individuals and entities use to transfer the price risk of ownership or potential ownership of commodities or financial instruments, or the price risk of their normal business, to those who are willing to carry these risks in return for a possible profit. This risk-shifting process is known as hedging.[1] Those who seek to shift risk are

[1]Hedging is generally understood to be a substitute transaction for positions to be taken at a later time in a physical marketing channel, when it is economically appropriate to reduce risk.

known as hedgers and those willing to assume risk, in return for potential profit, are known as speculators. Speculators, unlike hedgers, generally have no interest in the underlying commodity; they are interested solely in speculating on the extent and direction of future price changes. By standing ready to purchase or sell futures contracts, speculators increase the liquidity, efficiency, and competitiveness of markets because of their readiness to deal in futures contracts.

All futures trading is required to be conducted on organized exchanges using standard contracts. These futures contracts are agreements to buy or sell a designated quality and quantity of a particular commodity at a specific time in the future at a price agreed to at the time the contract is made.

Although contracts can be fulfilled by either actual delivery of a physical commodity, or by cash settlement, depending on the terms of the contract, the existence of organized exchanges and their associated clearing organizations creates a secondary market for these instruments. A person who enters into a contract to buy a commodity can offset it with one to sell the same commodity and never have to take or make physical delivery of the commodity (see ch. 6 for a discussion of how the exchanges and the clearing process work). Differences in the prices of offsetting contracts represent gains and losses that are usually settled in cash. Generally, fewer than 5 percent of futures contracts traded result in delivery. Most deliveries are accounted for by hedgers, although not all hedgers take delivery. Speculators, on the other hand, almost always offset a contract to purchase with one to sell, or vice versa. The following example illustrates these trading maneuvers.

A farmer plants his crop in April for harvest and sale in December. The price of the crop he sells in December will be determined by market conditions at that time and could vary significantly from the price that crop would sell for in April. The farmer can limit the price risk (hedge) in this case by using the futures market.

Assume that the farmer can profit on his anticipated crop yield if the price in December is the same or higher than the April price. Also assume that his December crop yield is what he expects. In essence, he can protect himself financially by selling his crop in April—at a December price determined by market conditions in April—for delivery in December. Then, if the delivery price in December is lower, he has insured a profit because he sold in April at the higher price. If the delivery price in December is higher, he loses the larger profit he could

have had, but he has protected himself from a potential loss, and will still profit.

The farmer can achieve this result in two ways, both of which involve the futures market: (1) he can sell and subsequently buy a futures contract himself on a futures exchange or (2) he can sell his potential crop directly to a willing buyer in April (this is called a cash forward contract) who could then use the futures market in the same way the farmer would to hedge the crop's price. In April, the farmer (or buyer) will sell a futures contract for December delivery of the crop he has planted (or bought). Then, in December, if the cash price of the crop has decreased, the farmer (or buyer) can buy back the contract at a lower price. His profit is the difference between the price of his contract to sell and the lower price of his contract to buy. The profit roughly offsets the loss suffered by having to sell the crop in December at a lower price than expected. Conversely, if the cash price of the crop has increased, the farmer (or buyer) has to buy back the contract at a higher price, causing a loss on the futures contract which will be offset by the increased price received for the crop. Thus, by selling futures contracts directly, or by selling the contract forward, the farmer can reduce his risk when he plants his crop in April and ensure some profit —although the profit may sometimes be less than he might have received on the open market.

In practice, only a small percentage of farmers use futures to hedge the price of their crops. A larger percentage sell their crops in the cash forward market and many sell for immediate delivery at harvest. It should also be noted that the same risk-reduction effect can be obtained by the farmer (or buyer) by actual delivery of the crop against the original contract sale. This obviates the need to buy the contract back at harvest but is possible only if the crop is deliverable against the standardized futures contract.

Speculators generally have no interest in making or taking delivery of a crop, unless the markets make it profitable to make or take delivery of the commodity. They enter a futures contract either buying or selling, depending on whether they expect the price of the crop (or whatever commodity they buy) to increase or decrease. If the speculators forecast prices correctly, they profit; if not, they lose.

Since the early 1970s, new futures contracts have been created based on physical commodities such as gold and crude oil as well as financial

instruments, a group of such instruments, and stock indexes. The contracts enable the buyer or seller to hedge or speculate on the price of these instruments, be it the price of a currency, interest rates, government securities, mortgage based securities, or the value of an index based on composite prices of a group of securities.

For example, the portfolio manager of a firm using government securities as an income producing investment can hedge against the loss of the portfolio value by using the types of futures described above, called "financial futures." The price of government securities is based on the interest rate yield, which fluctuates inversely with the value of the security. The manager can hedge against a rise in interest rates by selling a security-based futures contract. If rates rise, the manager will realize a gain in the futures market by buying back the contract at the lower price. This gain will approximate the loss in value of the securities portfolio.

While the strategies described above are generally simplified, they demonstrate how the futures market may be used by hedgers and speculators.

The Development of Futures Trading and Regulation

United States commodity exchanges, where futures are traded, have antecedents in the medieval trade fairs of 12th century Europe. At these fairs, trading became formalized with scheduled markets at fixed times and places. Producers and merchants in the United States first formed similar centralized commodity markets in the late 1700s for trade in eggs, butter, vegetables, and grains. These commodity exchanges were largely cash markets for spot or immediate commodity delivery.

These early regional markets often experienced unstable market price swings resulting from gluts of low priced commodities at harvest time and commodity shortages with high prices shortly after harvest. These problems were compounded by insufficient storage facilities and transportation systems. However, as transportation and storage facilities improved, large scale worldwide trading became possible, and better organized and specialized markets were needed.

In addition to futures contracts, another commercial practice known as forward contracting evolved. This type of contract is between the buyer and seller and is not executed on an exchange. Rather, the buyer and seller would agree in advance to the terms of the sale which would be executed when the goods arrived. This contracting form helped solve

the problem of rapid price movements resulting from excesses and shortages in supply and demand of commodities.

The evolution of the commodity markets led to the development of standardized futures contracts which included

- development of designated commodity warehouse facilities to ease the delivery process;
- commodity quality standards, since commodities vary in size, weight, etc.; and
- standard contract sizes.

According to the study on futures and options recently published by the Board of Governors of the Federal Reserve System, the CFTC and the SEC,

"Although the first futures contracts were frequently fulfilled by delivery of a commodity, it was found early in the development of futures trading that terminating a futures position by taking an opposite position in the market (termed offset) was often desirable. The execution of offsetting positions prior to delivery was initially conducted on a broker-to-broker basis outside of exchange rules. For example, if broker A were obligated to sell broker B wheat for May delivery at $3.15 per bushel and broker B were obligated to sell broker A wheat for May delivery at $3.17 per bushel, the commitments could be offset prior to delivery by A giving B two cents a bushel.

"As the volume of futures trading increased, exchanges attempted to facilitate settlement by forming clearing organizations. The Chicago Board of Trade created the first clearinghouse in 1884. This clearinghouse cleared and confirmed trades between clearing members and performed other bookkeeping and accounting functions. However, offsets were still arranged on a broker-to-broker basis.

"Complete clearing systems comparable to those in existence today were adopted in Minneapolis in 1891 and Kansas City in 1899. These clearinghouses were separate organizations, distinct from the exchanges. Although initially there were no requirements that all transactions had to be cleared through these clearinghouses, in practice most transactions were so cleared. After a futures transaction was executed on the floor of the exchange, the clearinghouse interposed itself between the original parties and became the second party to each side of the transaction. In addition, clearinghouses required open positions to be marked to market every day, and many established funds to guarantee payment in case of default by a clearing member. The first guaranty fund was established by the now defunct New York Produce Exchange in 1904."[2]

[2]A Study of the Effects on the Economy of Trading in Futures and Options, The Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, and the Securities and Exchange Commission; December 1984, pp. III-5, 6.

Few, if any, of these benefits were apparent to farmers during this period, who pictured commodity exchanges as fostering unbridled speculation, recurrent market manipulations, and spectacular price fluctuations. Serious concerns were raised about whether the benefits of the market to the economy during the late 1800s were outweighed by speculative excesses and abuses of the system. The irresponsible trading and lack of effective market regulation in this early period stirred up resentment and opposition to futures trading that still exists to some extent. From these abuses stemmed repeated efforts by various state legislatures to abolish futures trading. Agitation to abolish futures trading eventually gave way to a uniform system to regulate the futures industry.

Legislation Affecting the Futures Industry

Trading in commodity futures contracts and commodity options is governed by the Commodity Exchange Act, as amended. The Commodity Exchange Act of 1936 was significantly amended in 1968, and was also amended by the Commodity Futures Trading Commission Act of 1974, and the Futures Trading Acts of 1978 and 1982. The Futures Trading Act of 1982 extended the funding authority for the CFTC for an additional 4 years and thus its ability to administer the CEA through September 30, 1986.

During the 1920s, falling commodity prices, farm depression, and speculative excesses on the grain exchanges led to demands for federal regulation. The Grain Futures Act of 1922 was designed to allow the federal government, through the Department of Agriculture, to deal with these excesses. The Act required exchanges to be federally licensed or "designated" as contract markets. In order to receive designation, the exchanges had to take responsibility for preventing price manipulation by their members.

Between 1936 and 1968, several changes were made to federal legislation—changes that slowly extended regulatory coverage to additional commodities. Also, shifts in the economy brought customers from the general public into the futures markets in growing numbers, and additional speculators were attracted to the futures markets by wide price swings and the possibility of large profits. To assure that futures markets operated properly, careful supervision of the markets was deemed essential. As the futures markets expanded, exchanges would have to perform their self-regulatory role better in order to provide a market in which the public could have confidence.

The Department of Agriculture, through the Grain Futures Administration (from 1922 until 1936), the Commodity Exchange Administration (from 1936 to 1947), and the Commodity Exchange Authority (from 1947 to 1975) regulated the futures industry. However, as a growing number of nonagricultural commodities which were not subject to regulation under the CEA, such as gold, silver, and foreign currencies, began trading on American exchanges in the early 1970s, the Congress set up an independent agency, similiar in organization to the SEC, to oversee futures trading.

The Commodity Futures Trading Commission Act of 1974 created the current regulatory structure, consisting of industry self-regulation with government oversight by the CFTC. The 1974 act gave the CFTC

- oversight responsibilities for all futures exchanges and all futures and options contracts traded thereon;
- authority to impose stronger sanctions over the exchanges than those of the U.S. Department of Agriculture;
- expanded responsibilities over customer complaints against industry professionals;
- greatly increased federal agency enforcement powers; and
- authority to form a self-regulatory organization patterned after the NASD. This authority led to the formation of the National Futures Association.

The CFTC, therefore, was created to ensure that a single, expert agency would be responsible for developing a coherent regulatory oversight program while allowing the exchanges to be self regulated.

The reasons for federal regulation of futures, as cited in the Commodity Exchange Act, were grounded in concerns over the markets' susceptibility to excessive speculation, manipulation, fraud, or other irresponsible practices. Though the federal government has had a role in regulating futures markets for 60 years, with self-regulation as its linchpin, the theory behind this arrangement is that exchanges should move more promptly and effectively than government. Furthermore, self-regulation is meant to take the day-to-day oversight out of federal hands to reduce government expenditures.

How Futures Contracts Are Traded and Regulated

The futures industry functions under a scheme of self-regulation and federal oversight in much the same way as the securities industry operates. The futures SROs and the CFTC seek to insure that futures contracts are traded efficiently and within the framework of related laws and rules. To achieve this goal, SROs facilitate trading (except for NFA); establish, review, and enforce standards of conduct; regulate ethical standards, business practices, and financial responsibility of members; monitor the marketplace for manipulations and attempted manipulations; conduct investigations of alleged violations; and discipline violators of SRO rules.

CFTC maintains its oversight function by requiring approval of new and amended SRO rules, conducting surveillance of the markets, and conducting various inspections of the SROs to determine how well they police themselves. Direct regulation by CFTC comes through its independent investigations into illegal activities, prosecution of alleged violators of futures laws, and implementation of regulations which SROs and industry professionals are mandated to follow. In addition, CFTC conducts its own procedures for deciding claims from customers seeking monetary damages from brokerage firms, a function which has no SEC equivalent. On top of this, CFTC is the sole regulator of leverage contracts[1] and dealer options.[2]

How Futures Are Traded

Futures trading is conducted much differently than stock trading. The futures exchanges house centralized auction markets (called designated contract markets) where standardized contracts, based on quantity and quality of commodity, are bought and sold, for future delivery, by open outcry. The Commodity Exchange Act requires that all trading occur by open outcry on the floor of the exchange. Unlike securities trading, which allows transactions to be executed off the floor, futures transactions must be executed in a designated trading pit on the exchange floor.

While securities transactions involve the purchase or sale of stocks or bonds for example, futures transactions do not involve the purchase or sale of the underlying commodity. By depositing a sum of money, which

[1]A leverage contract is a standard agreement calling for delivery of a commodity with payments spread out over a period of time. These contracts are not traded on exchanges but, rather, through leverage transaction merchants.

[2]A "put" or "call" on a physical commodity, not originating on or subject to the rules of an exchange, in which the obligation for performance rests with the writer of the option. Dealer options are normally written by firms handling the underlying commodity and offered to public customers, although the reverse may also be true.

is a security deposit that provides assurance that the investor will perform under the futures contract, the investor or market user purchases protection against or speculates on rising or falling prices. When one maintains a position in the futures market, he or she does not own the underlying commodity but, rather, is able to profit or lose from price movements based upon the underlying commodity. When a futures contract is entered into, no physical commodity is purchased.

In addition, because of the high risk in trading futures, the Commodity Exchange Act requires futures commission merchants to provide customers with a risk disclosure statement when setting up a futures trading account.

Futures Contracts Are Purchased Using Margin as Good Faith

Buyers and sellers of futures contracts, unlike the vast majority of those buying securities, make a "good faith" deposit with their brokers called a margin payment. This margin covers the risks of price movements of the underlying commodity. Thus, futures contracts are highly leveraged financial holdings. For example, a Chicago Board of Trade official told us that, at the CBT, an individual can purchase a $100,000 Treasury bond futures contract by putting down as little as $2,000. The $2,000 is the initial margin which a customer must deposit with his/her futures commission merchant (FCM). (The FCM is the equivalent to a broker/dealer in the securities industry and is explained in more detail on p. 72.) Margins are set by the exchanges in the futures industry and the CFTC is precluded by statute from setting margins. However, FCMs can require a higher margin deposit than mandated by the exchange. Customers must set up their accounts with the FCM before trading futures contracts. This account is intended to insure customer performance in fulfilling the obligations of the contract should the market price move against the customer's position.

At the end of each trading day, each customer's position is tallied. If the market has moved in the customer's favor, the FCM adds an appropriate amount to the margin account. This money can either be withdrawn, held by the FCM, or used to open new positions on additional contracts. However, should the market move against the customer, the margin account is reduced. When the account falls below a specified level called "maintenance margin," additional cash must be deposited by the customer to restore the account to the level of the initial margin. If the customer does not meet the margin call, the position may be liquidated (by selling or buying contracts), with the broker taking normal commission fees and returning the remainder to the customer.

The amount a customer deposits in an trading account varies depending on

- the number of contracts the customer trades,
- the margin required by the particular exchange,
- the margin required by the futures commission merchant, and
- the contract traded.

In addition to setting up customer accounts, full service brokerage firms assign to customers an "account executive," also known as an associated person, who is comparable to a registered representative in the securities industry. The account executive

- explains trading rules and procedures to customers,
- provides the necessary documents and insures they are complete,
- provides a risk disclosure statement,
- notifies the customer of prices and market conditions,
- reports completed and incomplete market orders to the customer,
- serves as a liaison between the company's research department and the customer,
- assesses the customer's financial integrity and responsibility, and
- requests additional margin money when the customer suffers losses.

Participants in the Futures Trading Process

Futures trading participants can be divided between those firms and employees who deal with the public and those on the exchange floor conducting trading.

Futures Professionals Dealing With the Public Have Various Roles, Responsibilities, and Restrictions

Five major categories of participants provide a link between futures investors and the trading floor. These are:

- Futures Commission Merchants (FCM) who are similar to broker-dealers in the securities industry. These are full service brokers who solicit new customers, give trading advice, and accept both customer orders and funds.
- Introducing Brokers (IB) who solicit customers for FCMs and can accept customer orders for FCMs. However, an IB may not accept customer funds. IBs generally function as agents of FCMs.
- Commodity Trading Advisors (CTA) who sell trading advice to customers and may, in fact, manage customer accounts deposited with an FCM. CTAs may not accept customer funds.

- Commodity Pool Operators (CPO) which are similar to mutual funds in the securities industry and do accept customer funds.
- Associated Persons (AP) a person associated with any futures commission merchant, introducing broker, commodity trading advisor, or commodity pool operator as a partner, officer, or employee. Also, any person occupying a similar status or performing similar functions, in any capacity which involves: (a) the solicitation or acceptance of customers' orders (other than in a clerical capacity); or (b) the supervision of any person or persons so engaged.

Exchange Floor Participants Conduct the Trading

Exchange floor trading of futures contracts involves several types of individuals — floor brokers, floor traders, floor order clerks, and runners.

Floor brokers and floor traders are those in the pits conducting the trading. The difference between these two players concerns their relationship to public customers. Floor brokers trade for the public either from their own customer base or as an employee of an FCM, receive a commission for this, and must be licensed by the CFTC prior to executing trades for customers. Many floor brokers are "dual traders" as they trade for the public and for their personal accounts. Floor traders, on the other hand, trade strictly for their own account.

Floor order clerks are employees of futures commission merchants who receive orders from the account executives or customers directly and have them directed to the proper trading pit. In addition, the floor order clerks relay completed trade information back to the account executive for relay to the customer.

The link between the floor order clerk and the floor broker is completed either by a runner or through the use of hand signals. The runner's job is to take the order cards from the floor order clerk and deliver them to the assigned floor broker in the proper trading pit. The runner also brings information on completed trades from the pit to the floor order clerk. According to CBT and CME officials, hand-signals are frequently used to expedite customer orders. With this particular procedure, the floor order clerk takes the customer's order over the telephone and hand-signals the order to a floor clerk standing on the rim of the appropriate trading pit. That floor clerk informs the floor broker of the quantity, price, and futures contract that is to be executed on behalf of the customer. The floor broker executes the order on behalf of the customer,

informs the floor clerk of the transaction, and the floor clerk hand-signals the completed transaction back to the floor order clerk who informs the customer that the transaction is completed. The floor broker ultimately fills out a trading card to record the fact that the transaction occurred, and the floor order clerk will have prepared a written order which is time-stamped at the floor desk upon receipt of the order and upon confirmation from the floor clerk that the order has been executed.

Exchange Floor Trading of Futures Contracts

The mechanics of trading futures contracts on the nation's exchanges are similar. Each exchange provides a trading floor, segregated into separate trading areas, called pits, in which individual products are traded. Although trading on the exchange floor is by open outcry and competitive, it is not open to the public. Exchange rules limit access to their trading floor to members or their representatives only. Organizations and individuals that want to trade futures and who are not members must place their orders through a member broker or brokerage firm, which will execute orders for a commission.

With the establishment of an account, as explained above, the customer is able to place an order with a brokerage firm. Generally, the customer telephones the assigned account executive with the order. The executive makes a hard copy of the order, time-stamps it, and then relays it by telephone or computer to the firm's order clerk on the exchange floor. This clerk then writes up the order, time-stamps it, and then relays the order to the firm's floor broker in the designated trading pit via a runner, messenger, or hand signals.

The floor broker reviews the order and, based on the type of order and where the market is currently trading, determines whether the order can be filled. The broker has no discretion as to when an order is to be filled unless he/she has been given discretion by the customer in writing.

When the customer's order price coincides with the market price, or if the order is "at the market," the floor broker attempts to execute the order by open outcry and hand signals. If another trader in the pit accepts the terms, the trade is executed and the customer order filled. As with securities, no paper changes hands between the two brokers. However, each floor broker must record how much was bought or sold, from whom, the price paid or received, and the time designation. The time designation used by the CME and CBT is a bracket period, which is a

thirty minute time period utilized by the exchanges for determining the approximate time of execution of an order.

In instances where a customer's order is not a market order or is not to be executed at the prevailing market price, the floor broker holds the order. The broker prioritizes all unexecuted orders by price and time so that when the market moves to the order price, the orders are executed in order of receipt by the broker.

With the completion of a trade in the pit, exchange employees record the time and price of the transaction and report it electronically to the exchange floor quotation board. This allows everyone on the exchange floor to know the price of the last trade for contracts in each commodity traded. Simultaneously, prices are disseminated to other markets, brokerage offices, and trading facilities worldwide by various telecommunications systems. The exchanges maintain time and sales registers which indicate the prevailing prices in each commodity at various time intervals. This helps customers determine, with some certainty, whether the price they received was appropriate.

While this price information is being recorded and displayed, the floor brokers executing the trade either returns the order to the runner who, in turn, brings it to the floor order clerk or has the floor clerk hand-signal to the floor order clerk that the trade has been executed. Upon receipt of the executed order from the runner or upon confirmation via hand-signals from the floor clerk that the order has been executed, the clerk time-stamps the written order and telephones either the account executive with the trade data, who in turn notifies the customer of the order execution, or the customer directly with notification of the order's execution.

Clearing Corporations Match Trades and Transfer Money Between Parties

Futures transactions are matched at the clearing organizations. Clearing organizations serve several important functions, such as

- matching both sides of transactions;
- acting in place of a clearing member if the member defaults; and
- helping to ensure the exchanges' financial integrity.

Comparison of trades is done to verify that every buy position has a corresponding sell position and vice versa. Throughout the day, all trades are submitted to the clearing organization by the firm which is responsible for the trade. Unmatched trades result in "outtrades" and

the firms or brokers involved try to determine where an error occurred. Once a trade passes through the comparison process, the clearing organization substitutes itself in every transaction that clears as buyer from the seller and seller to the buyer. With this arrangement, the original buyer and seller need not deal with one another.

Because of this procedure, with the clearinghouse guaranteeing the trade, each trader firm must deposit "good faith" funds—essentially a margin account—with its clearing firm, which, in turn, deposits margin at the clearing corporation. Clearing organizations make margin calls against FCMs just as brokers do when the market has moved against a customer. Each day, each futures contract is marked to the market; no credit is extended by a clearing house to its clearing members. Depending on the positions carried and market movements, the clearing house will either debit or credit the clearing member's customer and house accounts. These two general accounts are separate, and amounts to be paid to or received from them are not netted. Clearing members are required to satisfy their obligations to the clearing organization by the opening of business the following morning. Also, according to CBT officials, in many situations, the clearing organization has the ability to call for additional margin deposits which must be met within 1 hour. Clearing members handle individual customer accounts in the same fashion, debiting and crediting them depending upon the positions in the account and the movement of the market. When an account becomes under-margined, the firm sends a margin call to the customer, which must be met within 3 days or the firm will be required to reduce its adjusted net capital by the amount of the margin call in calculating its capital requirements.

Regulation of the Futures Markets Is a Combination of Self-Regulation With CFTC Oversight and Direct Regulation

Futures SROs play an extensive role in industry regulation. These SRO responsibilities include proposing and amending rules governing member conduct and trading; setting qualifications for futures industry professionals; monitoring daily trading activity; examining members for financial health and compliance with rules; investigating suspected rule violations; disciplining members who violate SRO rules; and, responding to inquiries and complaints from investors and the members. Futures exchanges generally have separate departments with paid staff to fulfill their regulatory responsibilities.

CFTC provides oversight of SRO regulation by conducting regular or periodic examinations of SROs for compliance with their regulatory responsibilities; maintaining a surveillance system for oversight of daily trading

activity; and reviewing and approving SRO rules and rule changes. In addition to this oversight, CFTC provides direct regulation by conducting independent investigations into alleged wrongdoing by members of SROs, the SROs themselves, and those beyond SRO jurisdiction. The final aspect of direct regulation—one which has no SEC counterpart—is the mechanism CFTC has to hear customer complaints for reparations and award damages if need be.

The following describes industry regulation by function. For each function, we detail how the SROs accomplish their self-regulatory duties and how CFTC oversight is achieved.

SROs Establish Rules of Trading and Conduct Which Must Be Approved by CFTC

The Commodity Exchange Act requires SROs to submit all rule changes and new rules to the CFTC for review. Rules expected to have an economic impact are reviewed by the Division of Economic Analysis. Rules that relate to SRO operational or technical matters are reviewed by the Division of Trading and Markets. The two groups coordinate to determine which will review the rule; if the rule is thought to have both an economic and operational impact, it may be reviewed jointly.

Rules that pertain to the terms and conditions of the market, such as delivery terms, must be considered by the Commission before they take effect. If it is thought that a rule is of major economic significance, notice of the rule must be published in the Federal Register at least 30 days before it can be approved. The Commission has 180 days after receipt, or within such longer period to which the contract market agrees, to act on the rule submission; if it does not take any action, the SRO is authorized, but not obligated, to put the rule into effect.

With limited exceptions, all other rules such as those dealing with trading procedures and membership must be submitted to the CFTC by the SRO at least 10 days before they go into effect, and must be acted upon by the CFTC within 10 days of receipt. Under authority delegated by the Commissioners, the staff must take one of the following actions:

- notify the SRO that its rule can become effective;
- let the 10-day period elapse and do nothing, after which the SRO is authorized to put the rule in effect;
- recommend that the Commissioners review the submission;
- notify the SRO that the CFTC plans to review the submission in greater detail.

In rule submissions that need additional review, the CFTC has to review them within 180 days after receipt, or within such longer time period to which the contract market may agree. If the rule is not approved, disapproval proceedings must be initiated during this time period. The CFTC staff is given an additional year to take action; if none is taken, the rule becomes effective. However, roughly 90 to 95 percent of all these rules are processed routinely. When a rule does not violate the Commodity Exchange Act and/or CFTC regulations, the CFTC staff is required to let it become effective.

Certain other rules are exempt from the 10-day period. These are primarily administrative in nature and include rules concerning floor brokers being required to wear jackets, who can be admitted to the exchange floor, and the scheduling of exchange tours. The CFTC does not authorize such rules, and these become effective upon adoption by the SRO.

The CFTC rarely disapproves rules. The SRO staff is more inclined to negotiate with the CFTC staff to modify the rule submission rather than have the rule disapproved. The CFTC has the authority to initiate disapproval proceedings against any rule (except for those pertaining to levels of future margins) regardless of when it went into effect. This allows the CFTC to exercise control over the SRO rules in place before the agency's creation in 1974. SROs can appeal CFTC rule disapproval decisions in the U.S. District Court.

Firms and Individuals Transacting a Futures Business Must Be Properly Registered

Exchange staff register and help approve members. When members wish to sell their memberships, they do not individually and directly solicit buyers but, instead, notify the exchange of their intent and desired offering price. The exchange staff then publicly posts the offering price. This permits everyone an equal opportunity to bid on the seat. Once someone responds to the exchange with a bid, the exchange staff brings the buyer and seller together. However, merely agreeing on a sale price is insufficient to secure membership. While individuals applying for membership to the CBT need not own a seat at the initiation of the application process, individuals applying for membership to the CME must own a seat prior to the initiation of the application process. Applicants who are not approved for membership at the CME are required to sell their seat immediately.

After agreeing on a sale price, but before acceptance as a member, several intermediate steps occur. The exchange's membership committee,

consisting of exchange members elected by other members, must approve the applicant. However, the membership committee tries to determine the financial/moral integrity and acceptability of the buyer. The committee seeks input from the membership. For example, if any members are aware of improprieties in the applicant's previous business, these members are solicited to present their observations to the committee. Furthermore, in the case of the Chicago Mercantile Exchange, the legal department enlists a private detective agency to conduct background investigations of applicants.

Once approved, the buyer pays the bid price to the exchange which applies these funds to any outstanding obligations of the seller (such as fines or dues) and then forwards the remaining balance to the seller. The new member pays periodic dues to the exchange and must comply with exchange rules.

CFTC and NFA Register Futures Professionals

The Commodity Exchange Act (CEA) requires those who trade for the public, or advise the public on futures contracts or options on futures, be registered to do so. Until December 1984, the CFTC had sole responsibility for the registration function. However, these registration processing procedures for several groups of registrants were transferred to the National Futures Association as an outgrowth of the 1983 CEA amendments. These amendments allow for registration to be conducted by a national futures association. Currently, the NFA processes registrations for all futures professionals except floor brokers, and leverage transaction merchants and their associated persons, which are still processed by the CFTC. Although the registration process is now conducted by the NFA, the persons and firms are technically registered with the CFTC under the CEA.

Requirements for NFA registration include submitting a completed application, passing a commodities exam (series 03 exam administered by NASD), paying the proper fee, and submitting fingerprint cards. NFA computer codes the application information and runs an identifying check against both CFTC and SEC data bases. This enables NFA to determine if either of the regulatory agencies has taken a disciplinary action against the applicant. Concurrently, the fingerprint cards are sent to the FBI for a criminal record check.

NFA has authority to approve registration and grant temporary licenses so the applicant can work while registration proceedings are conducted. In addition, NFA has recently been granted CFTC approval to condition,

deny, suspend, restrict, or revoke registrations. Prior to this CFTC rule change of September 30, 1985, NFA had to request CFTC to institute the above-mentioned registration actions. Now, NFA may act on its own to condition, deny, suspend, restrict, or revoke registrations, although CFTC maintains its power to overturn an NFA decision in these circumstances.

Two types of proceedings are followed by NFA which differ according to whether the action is being taken against an applicant for registration or against a current registrant. For applications not approved by NFA, NFA sends written notice to the applicant that he/she is subject to a statutory disqualification under the Commodity Exchange Act. This allows the applicant to withdraw the application before denial proceedings are instituted. Statutory disqualification can be based on such things as non-disclosure of information on the application or a prior registration having been revoked or suspended where the period of suspension has not expired. If the applicant wishes to challenge the registration denial, the only avenue is to prove that the facts surrounding the denial are inaccurate. The applicant is not entitled to a hearing and, unless the NFA allegations are specifically challenged in writing, the application is considered to have been withdrawn.

A second procedure is used for actions taken against those already registered. Here, a registrant is served a Notice of Intent to suspend or revoke registration and is entitled to make a written submission to the NFA Director of Compliance who may submit it to the NFA President within 10 days. The NFA President then makes a determination based on the NFA information and the registrant's reply as to whether a statutory disqualification should be made. If the President determines that a disqualification is not called for, the President issues an order so stating. If the President decides that a disqualification is called for, the registrant is suspended and given 20 days to show reason to the NFA Membership Committee why the registration should not be revoked. The suspension remains in effect until a final NFA order has been issued. Likewise, the NFA Director of Compliance makes a submission to the Membership Committee showing reason why a registration should be revoked, consistent with CFTC rules.

Oral hearings may or may not be conducted depending on what sections of the Commodity Exchange Act may have been violated or where extraordinary circumstances surround a case and the Membership Committee allows a hearing.

After the evidence has been weighed, NFA issues an order which becomes final on the day it is served on the applicant or registrant. An NFA final order must be filed with the CFTC at the time it is served on the applicant or registrant and must inform the aggrieved person that he/she may seek CFTC review of the NFA's determination. Also, CFTC may review any final NFA order on its own volition.

Futures Transactions Are Monitored Daily by Both the Exchanges and CFTC to Detect and Deter Illegal Trading Activities

Daily market surveillance of futures trading is conducted by the exchanges and the CFTC. The variables examined by these organizations are similar as are the types of trading practices the systems are designed to prevent and detect. When unusual trading patterns are detected, followup procedures are undertaken by the respective staffs to explain the activity. Should either an SRO or the CFTC determine that an investigation is warranted, it may refer the matter to its enforcement arm for investigation and possible disciplinary action.

Exchange Surveillance Staff Concentrate on Market Conditions Susceptible to Price Manipulation

Surveillance departments at the exchanges are primarily concerned with detecting price distortion and market manipulation. To accomplish this, the surveillance staff pays special attention to the exchange's speculative position limits which put a cap on the number of speculative contracts a trader may hold. If a trader exceeds these limits, he/she could (though not necessarily would) be in a position to "corner" or "squeeze" the market and manipulate the price of contracts because of the large number of contracts controlled, or could cause delivery congestion problems. According to CME officials, speculative position limits are closely monitored and violators are disciplined. While entities which have hedge approval from the exchanges may exceed the speculative position limits, these traders are also carefully monitored to insure that their trading is for the purpose of hedging and that they do not violate their hedge position limits.

Several sources of information, both external and internal to the exchange, are utilized by surveillance staff daily to detect unusual trading. External sources include publications such as the Wall Street Journal and other newspapers, and U.S. Department of Agriculture reports.

Internal sources consist of several computer generated reports which take into account various aspects of the previous day's or week's trading. Examples of these reports include:

- Large trader report which summarizes positions of large traders. CME and CBT have different definitions of large traders. CME defines a large trader as anyone holding 25 or more contracts in a commodity whereas CBT regards anyone holding more than 5 percent of the contracts in a commodity to be a large trader.
- Open interest/commitment report shows all traders with open positions both long and short at the end of the trading day.
- Watch report flags all trading activity which falls outside pre-established trading parameters set by the exchange.

During the course of their surveillance activity, exchange staff do not review all trading in every contract. Instead, surveillance staff concentrate on positions and trading in the next expiring contract as this is the time that contracts are traded most heavily and are most prone to manipulation.

Exchange Staff Pursue Suspicious Trading Activity

Exchanges use many sources of information to investigate unusual trading activity. These sources include news wire stories, statistics on deliverable supplies of commodities, information on the movements in prices in cash markets, weather data, and trading strategy information. In addition, other exchange staff, exchange members, and people in the industry may be consulted as well.

The individual trader is contacted to explain his/her trading activity, the positions held, future intentions, and economic justifications for carrying those positions. CME surveillance officials told us that, when traders are contacted in these situations, they often liquidate these positions.

If it is determined by the surveillance staff that violations occurred, the staff, with limited exceptions, presents a final report to the exchanges' business conduct committee for its review and possible imposition of disciplinary actions. Surveillance staff at CME may independently issue warning letters and cease and desist orders in very specific instances.

Exchange Surveillance Extends Beyond the Trading Floor

In addition to reviewing floor trading, SRO staff conduct surveillance outside the exchanges. For example, according to CME and CBT staff, they visit storage warehouses to verify deliverable inventories of physical commodities to ensure that sufficient volume is available at contract expiration. Furthermore, exchange staff monitor cash markets for the commodity underlying the futures contract. In the case of British

pounds, for example, CME monitors developments in the British economy which could impact pound futures.

CFTC Also Conducts Market Surveillance

Market surveillance at the CFTC is conducted mostly at the regional offices with most staff members located in the New York and Chicago regional offices. The Market Surveillance group, an office within the Division of Economic Analysis, surveys the markets to detect and prevent congestions, squeezes, and price manipulation, as well as violations of maximum positions traders may have (speculative limits). In addition, it analyzes the terms and conditions of proposed and existing futures contracts to assure they are not susceptible to manipulation or price distortion. Finally, it performs special economic studies of market performance.

FCMs are required to submit reports of large customer positions to CFTC and to the exchanges on a daily basis. These reports are entered into CFTC's computer system which is capable of producing large trader position listings, by futures market, on the business day following the date of the FCM reports.

In addition, futures exchanges are required to submit summaries of trade activity to the CFTC on a daily basis. The data is run through CFTC's computer system which, through a predetermined set of parameters, pinpoints questionable trading activity. Market Surveillance is primarily concerned with open positions of large traders and comparisons of price relationships between futures contracts and the cash market price of a commodity.

The computer exception reports serve as a trigger for surveillance economists to gather more information to explain given trades. Questionable trading can usually be explained either through the economist's knowledge of market conditions or by comparing trading with historical trading patterns. When these sources do not offer an explanation for unusual trading activity, the surveillance economist informs his/her supervisor. This supervisor, in turn, contacts the Market Surveillance director at headquarters, to keep him apprised of unusual trading activity. The director and regional supervisor determine if a contract market requires "special watching." In addition, CFTC staff contacts traders and/or the exchange on a regular basis by telephone or personal interview to resolve questionable trading activity questions. CFTC Surveillance staff stated that, on average, 6 to 12 special watches are undertaken in a year.

The Market Surveillance Director briefs the CFTC Commissioners on surveillance issues at regularly scheduled (closed) weekly surveillance meetings. At times, the Commissioners themselves may become involved in resolving questionable trading activity. Often, Commissioners' attention to a surveillance problem results in the exchange taking action against its member rather than CFTC doing so. This is an infrequent occurrence, however, as only two to three surveillance problems per year rise to a level requiring action by the Commissioners.

SROs Examine Members to Assure Compliance With Rules and CFTC Monitors This Compliance by Inspecting the SROs

Each SRO performs routine audits of its members to assure compliance with its rules. These audits range from reviews of specific aspects of a member's performance to full scale audits of all of a firm's operations.

In addition, the SROs have formed a Joint Audit Committee to help avoid duplication of effort. Each firm has a designated SRO which examines the firm. If the firm belongs to more than one SRO, the designated SRO reports its findings to the other SROs of which the firm is a member.

CFTC also conducts examinations of the member firms to assure that SRO audits are adequate. In addition, CFTC performs audits of the SROs themselves to assure that floor trading practices and member audits are conducted within the regulations and that the SROs are effectively policing themselves.

SRO Examinations Are Conducted on a Routine Basis

The futures SROs have divided their inspection responsibilities. The National Futures Association inspects Futures Commission Merchants which are not members of an exchange and certain other FCMs which are exchange members but for whom NFA is the designated self-regulatory organization. Also, NFA inspects Commodity Pool Operators, Commodity Trading Advisors, and Introducing Brokers. Each exchange inspects all FCMs for which it is the designated SRO.

Full scale audits are conducted by the designated SRO every other year. These inspections include review of a firm's financial condition, compliance procedures, and sales practices relating to futures options.

The financial aspect of these audits includes a review of the firms' financial statements, which are submitted to the SRO, to determine if they are accurate. Each firms' net capital position is analyzed as well to insure compliance with CFTC and exchange regulations. The compliance portion of an inspection concerns how customer orders are handled, how

customer accounts are documented and segregated from the firm's accounts, and how discretionary customer accounts are traded, among other things. Finally, the options portion of an inspection is similar to the compliance section, but it also includes reviews of sales practices and customer complaints.

After the inspection is completed, the SRO staff presents the firm with a preliminary report on the findings. Then senior SRO staff review the inspection team findings and a formal report is issued to the member firm. (The designated SRO provides a copy of this report to the other SROs of which the firm is a member.) The firm is required to formally respond to the report within a specified period (15 days at CBT; 30 days at CME if major deficiencies are noted). At the CBT, the final report, which includes the firm's history and its record on prior examinations along with the firms' response, is forwarded to the Business Conduct Committee for its review. At the CME, only those inspection reports where major deficiencies are noted are forwarded to the Financial Subcommittee of the Clearing House Committee.

The Business Conduct Committee reviews the inspection and decides whether the findings merit disciplinary action. The Committee can issue preliminary charges. If charges are issued by the Committee, the firm can request a hearing or settle the charges. The committee may impose penalties such as fines and cease and desist orders. It can also order that a followup inspection be undertaken to insure that problems noted have been corrected. The member may appeal any penalty imposed to the exchange's governing board.

SROs Perform Other Inspections Besides Full Scope Audits

Occasionally, the SROs perform surprise inspections concerning a specific part of a firm's operations. Some of these are routine while others are prompted by information that some problem may exist. Also, in the year between full scope inspections, the exchanges perform "limited scope financial reviews" to maintain oversight of the financial condition of member firms. A limited scope review can also be initiated if the SRO feels a firm is in financial jeopardy. Since the audit groups review each firm's financial position on a daily basis, a limited scope review may be started from an observation by an audit group.

CFTC Conducts Inspections of SROs to Assure Compliance With Laws and Adequacy of SRO Examination Procedures

The CFTC's inspections of SROs are divided into three areas: financial oversight; trade practice/rule enforcement; and sales practices. These examinations were explained to us by CFTC officials.

Financial responsibility reviews focus on how well the SROs monitor FCM compliance with the net capital rule and the segregation of funds rule. The net capital rule is a measure of FCM liquidity and financial health. Segregation of funds mandates FCMs to keep customer funds separate from the firm's funds.

The CFTC regional office staff conduct field work at the exchanges on a quarterly basis resulting in a single annual oversight report. During the fieldwork, the CFTC examines SRO reviews of FCMs and takes into account shortcomings from prior reviews when conducting the examination. This enables the CFTC to prioritize the review's focus.

If serious problems are noted during the quarterly review, regional staff may immediately issue a compliance letter, which requests the SRO to respond with corrective actions planned, or a warning letter, which is similar to a compliance letter but involves a more serious violation of the Commodity Exchange Act. These actions are also noted in the annual oversight report.

When the field work is completed, CFTC headquarters staff drafts an initial report which generally is forwarded to the SRO. SROs generally have a week to review and comment on the draft. After SRO comments are received and the draft revised, CFTC Commissioners are presented with the report for their review. Division of Trading and Market officials (i.e. Division Director, Chief Accountant) then meet with the Commissioners individually to answer any questions which arise.

After these individual meetings, a closed meeting with the Commissioners and the above mentioned Trading and Markets officials is held for the Commission to determine whether or not to accept the report. Afterwards, the report is published with the confidential information deleted. CFTC generally requires SRO response within 60 days of the report's release.

Trade practice/rule enforcement reviews concern the floor trading process and the ability of an SRO to enforce its own rules. These reviews are announced to the SRO so it can make available those materials necessary for the CFTC work. Before announcing its review, however, CFTC looks over its previous oversight reports of the SRO in question, the SRO

response to those reports, and any problems which surfaced since the report was issued. In addition, CFTC reviews customer complaints and records of disciplinary actions taken by the SRO. This allows CFTC to prioritize the direction of the upcoming review.

Over the course of a trade practice/rule enforcement review, CFTC visits the SRO on at least three occasions. The first visit consists of interviewing SRO staff and gathering documents to be brought to the CFTC office for scrutiny. On the second visit, CFTC conducts additional interviews with SRO staff based on the materials reviewed. The final visit is an exit conference where CFTC's findings are discussed with the SRO.

After the above steps are completed, CFTC drafts a report and presents it to the SRO for comment. The draft report may be revised after SRO comments are received. The report is then presented to both the SRO and the CFTC Commissioners for their review. The rest of the process is similar to that of financial responsibility reviews.

Options sales practice audits consist of oversight audits of the options sales practice programs at the SROs and direct audits of registrants (such as futures commission merchants).

Oversight audits are announced to the SRO so that it can get the files ready for CFTC review. Before conducting the audit, CFTC audit staff confer with staff from other CFTC sections or divisions—Market Surveillance, Enforcement, Complaints—to gather any helpful information.

Some of the material reviewed at the SRO include audit files, audit schedules, and promotional materials used by the registrants. Review of promotional material enables CFTC to determine if the SRO is doing a sufficient job of analyzing registrant advertising. Interviews are also conducted with SRO staff. When the review is completed, an exit interview is held with SRO staff. The remaining steps dealing with Commission approval and SRO comments are similar to that of the above described reviews.

Direct audits of registrants are conducted on an as needed basis, usually when a problem surfaces or another CFTC division, such as Enforcement, requests that an audit be done. Routine audits of registrants are conducted by NFA.

Direct audits take place on a surprise basis so that the firm does not have time to alter its normal operating procedures. The reviewers consult with other CFTC divisions and review financial oversight reviews before visiting a firm.

When the report is completed, CFTC holds an exit interview with the firm but does not furnish it with a report. If deficiencies are noted, CFTC issues a warning letter.

SROs and CFTC Investigate Alleged Violations of Futures Rules and Laws and Take Disciplinary Actions

SROs are required by federal law to enforce their rules. To accomplish this, the futures SROs have staff devoted to investigating alleged violations of SRO rules. Futures SROs do not have authority to issue subpoenas or discipline nonmembers. When a subpoena is necessary to gain information from member firms, an SRO may refer the matter to CFTC or can suspend the member until the request for information is satisfied. When nonmembers are the target of investigation, the matter is referred to CFTC.

Investigations are undertaken at CFTC both independently and by referral from SROs or other sources. When these investigations expose probable violations of futures law, the CFTC pursues disciplinary actions either through its administrative law process, in U.S. District Court, or both.

SRO Investigations

Unlike market surveillance, which is meant to be preventative, investigative work is reactive. SROs receive leads from members, customers, informants, CFTC, and other SRO divisions, such as Market Surveillance and Inspections. Furthermore, the SROs generate leads internally.

Investigations staff members do not take disciplinary actions. Their investigations culminate in written reports. At the CME, the final report on the investigation is submitted to its Probable Cause Committee which has a role analogous to that of a Grand Jury. The Committee decides both whether the investigation should be forwarded for a disciplinary hearing and which committee at the exchange should conduct the hearing. However, we were told by CME officials, the Probable Cause Committee usually accepts the recommendations of the investigatory staff, although it sometimes adds or changes a charge.

Hearings are then conducted at both futures exchanges we examined. Investigation staff file reports with, make recommendations to, and

serve as "prosecutors" before the members of an SRO disciplinary committee. This committee decides whether the investigation should be continued or terminated, whether the evidence indicates a violation, and whether disciplinary action is warranted. At both exchanges, defendants are entitled to be represented by lawyers. The committee makes a ruling based on the evidence presented and, if deemed necessary, invokes disciplinary actions against the member. These penalties against members may include warning letters, cease and desist orders, fines, or suspension. A member may also be expelled, but this must be voted on by the Board of Governors.

However, the committee decision is appealable to the SROs' Boards of Governors. In addition, Board decisions can be further appealed to the CFTC and to federal courts.

CFTC Conducts Investigations of Individuals, Firms, and the SROs Themselves, and Seeks Disciplinary Action Where Appropriate

According to staff at the CFTC's Division of Enforcement, the Division investigates and prosecutes violators of the Commodity Exchange Act and CFTC rules. To accomplish this, the Division carries out investigations from its headquarters office in Washington, D.C., and its four regional offices in New York, Chicago, Los Angeles, and Washington, D.C. (Southern regional office). Enforcement is the largest CFTC division and in 1985 accounted for approximately 37 percent of its annual budget.

The regional and headquarters offices have similar authority to undertake and pursue investigations. However, if an investigation is sensitive or has national implications, the headquarters office handles the case.

The Division conducts investigations into alleged violations and litigates those cases in which it believes violations have occurred. The Division coordinates its activities with other CFTC divisions, SROs, and state, local, and federal enforcement organizations in order to identify and prosecute violators.

The Enforcement Division uses many sources of information, both internal and external, to develop investigations. Internally, the CFTC's Division of Trading and Markets, which oversees SROs, and the Division of Economic Analysis, which conducts market surveillance, supply data to Enforcement. Additionally, the Office of Proceedings, in the Office of the Executive Director, provides Enforcement with data based on customer filings for reparations. If a pattern of complaints against a firm or individual is received by the office, it will notify Enforcement. Sources

of information external to CFTC include customer complaints sent directly to the Enforcement Division, the futures exchanges, the National Futures Association, and other federal and state government agencies.

We were also told that investigations at the regional and headquarters offices are undertaken similarly. Enforcement Division staff members conduct a preliminary inquiry to determine if the facts warrant a full investigation. When the preliminary inquiry indicates possible CEA or CFTC rule violations, formal approval to open an investigation from either the division director or deputy director at headquarters is required. After approval is granted, Enforcement personnel proceed with a full investigation which includes the review of company records and the solicitation of explanations from the subject parties.

In cases where individuals or firms refuse to cooperate, the Division of Enforcement, with the Commission's approval, can issue subpoenas for witnesses' testimony and documents deemed relevant or material for the investigation.

When an investigation is completed, the Enforcement staff decides whether a violation has occurred. If no violation occurred, the case is closed. If a violation occurred, the division director submits a memo to the Commission outlining the facts discovered, the violations, and the recommended course of action for CFTC to take.

Many enforcement actions are settled rather than adjudicated. Settlements are arrived at when the Enforcement Division and the charged parties agree to a set of sanctions. In a typical settlement, the charged party accepts the findings of the Commission without admitting or denying guilt, and accepts the sanctions as well. All settlements require Commission approval.

If a settlement is not reached, the Commission reviews Enforcement's findings and will either accept, reject, or alter its recommendation for legal action. No legal action can be pursued without the Commission's approval. Upon approval, the Enforcement Division files the case in the appropriate legal forum.

CFTC seeks a variety of legal remedies through its administrative law process, U.S. District Court, or both. The action chosen by the Commission is determined by the type of offense, the appropriate remedy, and the immediacy of the need for legal action.

Administrative sanctions sought by CFTC include (1) denial, suspension, or revocation of registration; (2) civil monetary fines; (3) cease and desist orders; and (4) limitation on trading, such as losing the right to trade for one's personal account.

According to the Enforcement Division Director, when immediate legal action is necessary, CFTC seeks civil remedies such as a freeze of assets and/or a temporary restraining order in U.S. District Court. These actions are sought when customer funds are in jeopardy or when books or records might be lost. Although the Commission's approval is necessary to initiate this proceeding, emergency measures allow for the most senior Commissioner available to authorize the action if a quorum cannot be attained.

Other civil remedies include permanent injunction, disgorgement of illegal profits, and appointment of an equity receiver. In most cases where civil actions are filed, administrative remedies are sought as well. CFTC refers investigations of criminal allegations to the U.S. Department of Justice for its review and possible prosecution, although CFTC assists the U.S. Attorney if necessary.

Both administrative and civil decisions can be appealed. In administrative proceedings, the first level of appeal is with the Commission. If a party appeals a Commission order, the appeal leaves the CFTC and must be filed in a federal Court of Appeals. Appeals of civil actions are beyond CFTC jurisdiction and must also be filed in the U.S. Court of Appeals.

SROs and CFTC Have Procedures for Hearing Customer Complaints and Awarding Monetary Damages

Public customers have several avenues through which they can file for monetary damages against futures professionals. The customer may elect to file for arbitration proceedings at the exchange where the futures professional is a member or at the NFA, file a private right of action in District Court, or file a claim through the CFTC's reparations program. However, once a customer opts for a particular forum for the claim to be heard, the claim would probably not be heard in a different forum.

Exchanges Conduct Arbitration Proceedings to Settle Customer Complaints

When a firm becomes a futures exchange member, it agrees to submit to, and abide by, arbitration proceedings involving disputes where it is a party. Firms can question the exchange's decisions to submit to arbitration but, once the exchange's governing board has approved arbitration, the firm must obey.

Both the Chicago Mercantile Exchange and Chicago Board of Trade have arbitration committees made up of members. The CBT committee consists of 20 members, 5 of each are drawn from floor traders, floor brokers, brokerage firms, and commercial firms. CME's arbitration committee consists of five members, five alternates, and a governor to serve as chairman. In addition, both CME and CBT maintains a pool of "unassociated persons"—those not members of the exchange or any other contract market—for those arbitrations where customers request panels which include nonmembers. From these arbitration committees, panels of five are selected to hear an individual case.

Hearings are conducted before the panel and are similar to a trial with testimony, evidence, and rebuttal. Each party may be represented by an attorney if desired. Based on the hearings, the panel determines if damages should be awarded and sets the amount. Panel decisions are based on majority vote. At the CBT and CME, there are no limits to award amounts. Also, at CBT, in cases of claims under $2500, the process is streamlined and based solely on documentary evidence; no hearing is conducted unless deemed necessary by the arbitrators. Arbitration decisions at both the CBT and the CME are final.

There is no cost of filing for arbitration at CME unless a mixed panel is required and where the panel determines that a customer acted in bad faith when filing the claim. At the CBT, there is no fixed filing fee; the arbitration committee sets the fee based on the claim.

NFA Arbitration: A Second Alternative to Resolving Futures Related Disputes

NFA arbitration procedures are similar to those of the two futures exchanges explained above. All NFA members and their employees must abide by arbitration rules and decisions as a condition of their NFA membership.

Arbitration panels are selected from a pool of individuals, located in a number of states, whom NFA considers to be qualified to settle futures disputes. This pool consists of both NFA and non-NFA members, and customers can elect to have either an NFA panel or a mixed panel consisting of both NFA and non-NFA affiliated arbitrators.

Arbitration hearings are conducted for claims exceeding $2,500. Claims of a lesser dollar amount are settled solely on the documents presented to the arbitrators unless NFA directs otherwise. Claims of $5,000 or less are settled by one arbitrator while claims over $5,000 are heard by a panel of three. Hearings are run like court proceedings with opening statements, sworn testimony, cross-examination, submissions of evidence, and closing statements.

At the close of the hearing, the arbitrators make their decision as to an award, if any. Decisions are based on the arbitrators' knowledge of the industry; violations of specific rules or laws (such as the CEA) need not be proven. Arbitration decisions are not appealable within NFA but could be modified by NFA, when necessary. If the losing party wishes to have the decision overturned, he/she must seek a remedy through civil litigation.

The fee for filing a claim at NFA is based on the monetary damages sought. The fee structure is as follows:

Amount of Claim	Fee
$0 - $2,499	$ 50
2,500 - 5,000	100
5,001 - 10,000	150
10,001 - 15,000	175
More than 15,000	200 (plus 1% of excess over $15,000)

CFTC Also Settles Futures Customers' Claims for Monetary Damages

CFTC's Office of Proceedings, part of the Office of the Executive Director, administers the reparations program. This program permits decisions regarding claims where individuals are seeking monetary reparations from a registrant.

Before CFTC considers a reparations claim, the following criteria must be met:

- monetary loss must be the result of a violation of the Commodity Exchange Act;
- violations must be alleged against persons or firms registered under the Commodity Exchange Act;

- respondent must not be subject to pending bankruptcy proceedings or in receivership; and
- complainant must not be instituting a legal proceeding, based on the same set of facts, in another forum such as U.S. District Court or NFA.

In addition, formal complaints must be filed with the Office of Proceedings within 2 years of the time when the customer realizes violations may have occurred. Data requested on the complaint form include names and addresses of respondents, dollar amount of loss caused by violations of the CEA, method by which this dollar figure was calculated, charges alleged, and statements from the complainant that no alternative legal proceedings have been initiated and the respondent is not involved in bankruptcy hearings. These forms are sent to the Office of Proceedings accompanied with the appropriate filing fee for the requested CFTC complaint decision procedure.

The Director of the Office of Proceedings (or a delegated authority) reviews complaints to determine if the criteria for filing a claim have been met and all other questions have been adequately answered. The Director can return the complaint for more information, dismiss the complaint outright, or forward it to a proceeding clerk to commence processing. When an eligible complaint has been filed, CFTC notifies the respondent that a claim has been filed against it and requests an answer to the charges as well as the desired administrative procedure for settlement. The proper fee for the procedures selected is also requested. If the respondent fails to answer the charges, a default judgment in favor of the complainant is entered.

Three procedures are available for decision of reparations cases. The proper procedure is determined by the dollar amount of the claim and the desires of both the complainant and respondent. Each procedure has a different fee and, if the respondent opts for a more expensive procedure than that elected by the complainant, the respondent must pay the difference in cost between the procedures.

The least expensive and most expeditious option available is the voluntary decisional proceeding. In voluntary proceedings, decisions are made solely on the documents submitted by both sides of the action. No oral testimony is taken, a statement of CFTC findings is not issued, and appeals are not allowed. A judgment officer issues a final decision either awarding or denying reparations. This procedure has a $25 filing cost and can be instituted for an unlimited dollar amount.

Summary decisional procedures are undertaken with claims of $10,000 or less where the voluntary process was either not selected by the complainant, or not agreed to by the respondent. The filing fee for this is $100. The judgment officer may, at his/her discretion, hold hearings and allow for direct and cross examination of the witnesses and parties to the action. These hearings, if allowed, can be terminated at any time the judgment officer chooses. The number of motions which can be submitted are limited and the parties may not file "proposed findings of fact" or "conclusions of law." Initial decisions are final if no appeal is filed within 15 days or if the Commissioners do not place it on their own docket for review within 30 days.

When claims involve $10,000 or more and a voluntary proceeding has not been elected, the formal decisional proceeding is used. The fee for this process is $200. These cases are open to the full administrative law process and are decided by an administrative law judge within CFTC. An initial discovery process is overseen by a proceeding officer to allow the judges more time for hearings and rulings. As with the summary proceeding, administrative law judges issue an initial decision which becomes final if no appeal is filed within 15 days or if the Commission does not place it on its own docket for review within 30 days.

Appeals are allowed for only summary and formal decisional proceedings; parties to voluntary proceedings automatically forfeit the right to appeal. All appeals must be filed within 15 days of receiving an initial decision. First appeals are heard by the Commissioners. The Commission has delegated responsibility for initial review of appeals to the Opinions Section in the Office of General Counsel. The Opinions Section reviews an appeal and either dockets it on the Commission schedule for a review, rejects it outright under specified circumstances, or takes other appropriate action to facilitate or expedite Commission review. All further appeals leave the CFTC system and must be filed in U.S. Court of Appeals for further consideration.

Advance Comments From the Securities and Exchange Commission

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

January 17, 1986

Mr. William J. Anderson
Director
General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

Chairman Shad has asked me to respond to your letter of November 19, 1985, requesting Commission review of and comment on the General Accounting Office's draft staff study entitled "Self Regulation in the Securities and Futures Industries: How It Developed and How it Works."

As you know, several members of the Division's staff have met with John Maurello and other examiners from the General Accounting Office assisting you on the report throughout the preparation process. Division staff members also were provided opportunities to review prior drafts of the draft staff study and met with Mr. Maurello on two occasions to deliver and discuss Division staff comments and suggestions on those drafts. Those meetings were supplemented by a number of telephone conversations covering specific matters included in the draft report. The Division staff also was afforded an opportunity to review changes to the draft staff study proposed by the securities exchanges, the National Association of Securities Dealers, Inc. ("NASD"), and other entities contacted by the General Accounting Office's examiners in preparing the study.

The Division staff has reviewed and provided comments only on the introductory portions of the study and the first half of the descriptive materials, covering the securities markets. Except where incidental to that review, the Division staff has not sought to review or provide comments on the second half of the study, related to the futures industry. In the Division's view, the draft staff study accurately describes the responsibilities of the Commission with respect to the securities self-regulatory organizations, the activities of the self-regulatory organizations, and the interaction and relationship between the Commission and the self-regulatory organizations. In this regard, the draft staff study incorporates the vast preponderance of the specific substantive comments made by the Division staff during the informal review process. We believe the study will be useful in providing the Congress and the public with a better understanding of the self-regulatory and Commission oversight process.

Mr. William J. Anderson
Page Two

Without in any way detracting from the substantive discussion contained in the draft study, we would like to offer two general observations. First, the study's treatment of various self-regulatory organizations differs in degree of detail. For example, the study provides a much more extensive description of the rule filing and review process relative to the Municipal Securities Rulemaking Board ("MSRB") than it provides for the exchanges and NASD; conversely, it includes a relatively abbreviated discussion of the National Securities Clearing Corporation's self-regulatory responsibilities. These differences may be reflective of the level of detail provided by the various self-regulatory organizations in offering input for the study. For the most part, however, the study should not be read to suggest that there are substantially different relationships between the Commission and the various self-regulatory organizations. Thus, although the discussion of the rule filing process is more extensive with respect to the MSRB, the Commission follows substantially similar informal and formal procedures in processing the MSRB's filings and those of the other self-regulatory organizations. We do not view this factor, however, as in any way rendering inaccurate the descriptions or discussions contained in those sections.

See comment 1.

Second, Chapter 2 of the draft staff study contains a discussion of industry trends. It focuses primarily on the growing inter-relationship of the banking and brokerage industries. An even more relevant industry trend for the purposes of this report would appear to be the increasing closeness between the securities and futures industries, both with respect to the products offered by the competing securities and futures markets and the increasing integration of firms that provide brokerage, clearing and related services in the two industries. We believe it might be useful for the study to discuss this development.

In closing, I would like to express our sincere appreciation of the courtesy, cooperation and high degree of professionalism that characterized the efforts of Mr. Maurello and the other General Accounting Office examiners throughout the process of preparing and finalizing the draft staff study. If you or any members of your staff have any questions or believe we can be of further help, please don't hesitate to contact me at 272-2866 or Dennis Shea at 272-7497.

Sincerely,

Richard T. Chase

Richard T. Chase
Associate Director

cc: John Maurello

The following are GAO's comments on the Securities and Exchange Commission's letter dated January 17, 1986.

GAO Comment:

1. We agree that more information should be presented on the interrelationship between securities and futures markets. We have added a new section to chapter 2 concerning this matter. (See pp. 17-18.)

Advance Comments From the National Association of Securities Dealers

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

NASD

National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006
(202) 728-8000

February 7, 1986

Mr. William J. Anderson
Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

The National Association of Securities Dealers, Inc. ("NASD" or "Association"), is forwarding this letter in response to your request of November 19, 1985, for comments on the draft staff study entitled, "Self-Regulation in the Securities and Futures Industries: How It Developed and How It Works." In general, the Association believes the report is well-crafted and contains much useful information on the regulatory processes that have helped to shape today's securities markets.

However, in reviewing the most recent draft of the document, the Association noted four specific areas that merit consideration for expanded coverage. In another area, we would like to suggest some clarifying langauage. In the NASD's view, the inclusion of these adjustments to the document will improve the report by providing the reader with important and useful information concerning the securities industry's self-regulatory system and the role of the various participants in it.

The areas which we respectfully request be added pertain to the work of our Market Surveillance Committee, cooperative regulatory programs among the SROs, the Central Registration Depository and the NASD's entry into the options business. Each of these is addressed in the following.

NASD's Market Surveillance Committee

Now on p. 52.

- **Page 72: "SRO Investigations: Formation and Process"**

In Chapter 4, How Securities Are Traded and Regulated, under the section on self-regulatory organization investigations, the report points out correctly that enforcement of the NASD's rules and regulations rests primarily with its 13 District Business Conduct Committee ("DBCC"). In the NASD's opinion, the report should further note that these committees are locally elected by the NASD membership in the Districts where the committees operate. In the tradition of self-regulation, the NASD relies on this election process to ensure greater membership participation and involvement in the self-regulatory process.

In addition to its DBCCs, the Association maintains a Market Surveillance Committee which is a national standing committee appointed by the Board of Governors from among NASD members and NASDAQ issuers. Its primary responsibility is to act as a disciplinary committee to enforce market-related NASD and SEC rules. In that regard, the Market Surveillance Committee has the authority to initiate disciplinary proceedings in connection with apparent violations of requirements pertaining to members' participation in the NASDAQ System. These proceedings would cover such areas as violations of Schedules D and G of the NASD's By-Laws, insider trading, specialized options violations, and violations of the rules of the NASD's Small Order Execution System ("SOES") and other automatic execution systems.

Cooperative Regulatory Programs Among SROs

Now on p. 48.

• **Page 85: "SRO's Examine Members to Assure Compliance with their Rules and Federal Securities Laws and SEC Monitors this Compliance by Inspecting the SROs"**

One of the major reasons for the success of the securities industry's long-standing system of self-regulation is the efficiency this approach brings to the regulatory process. The efficiency of this process was greatly enhanced by virtue of agreements among the NASD and the Boston, Cincinnati, Midwest, Pacific and Philadelphia Stock Exchanges under which the NASD performs on-site inspections of approximately 200 dual broker-dealer members of these exchanges.

These agreements, reached pursuant to SEC Rule 17d-2, have a twofold purpose: first, to reduce the cost to the industry of duplicative regulatory programs; and, second, to minimize the disruption to members' operations caused by multiple regulators conducting multiple examinations.

In addition, the NASD and the NYSE have arranged to examine dual members of both organizations on a joint basis to streamline the regulatory process and reduce the burden on members. Also, an agreement among the NASD and the options exchanges to allocate regulatory responsibility for the options activity of dual members has also worked to lessen regulatory duplication.

With the addition of this information, the readers of the report will see that the current self-regulatory process provides the industry with a flexible approach to the protection of investors and maintenance of marketplace integrity.

Central Registration Depository

Now on p. 42.

• **Page 54: "Firms and Individuals Conducting a Securities Business Must be Properly Registered"**

Ensuring that persons who engage in the securities business meet minimum qualification requirements, is an integral part of securities regulation. Through this qualification process for securities sales representatives and principals, the self-regulatory organizations can exercise substantial control over who deals with the public and on what terms they do so.

As pointed out in the report, every associated person, other than those whose functions are solely clerical or administrative, must meet certain specified qualification requirements. These include the requirement that the individual pass a qualification examination applicable to the activities in which he plans to engage and that his firm register him with the NASD and applicable exchanges.

Almost all testing of securities industry personnel is done by the NASD with three quarters of those tests administered through the NASD's automated testing system. Computerized testing with video display of questions and immediate scoring at the conclusion of each examination is used to expedite the examination process and simplify test scheduling.

In virtually all cases, registration of an individual with a self-regulatory organization is accomplished by the employer filing a completed "Uniform Application for Securities Industry Registration or Transfer" (Form U-4) with the Central Registration Depository (CRD). CRD was developed jointly by the NASD and the North American Securities Administrators Association and, since 1981, has become the central processing facility in the securities industry for registering persons associated with a broker-dealer.

CRD consists of a central registration information data bank and an application processing facility, with each of its regulatory participants linked to the central facility through a nationwide network of CRD on-line terminals. The CRD data base houses records on more than 350,000 individuals active in the securities industry. During 1985, the CRD processed over 500,000 records of individuals relating to registration, transfer and termination.

In addition to NASD representative and principal registrations, the CRD System processes applications for agent registration in 51 jurisdictions. The District of Columbia, Puerto Rico and all states but Hawaii participate in CRD. As a result of agreements between the NASD and six securities exchanges, CRD also processes registrations for the Boston, Midwest, New York, Pacific and Philadelphia Stock Exchanges, as well as the Chicago Board Options Exchange.

The uniform application form for registration requires an associated person candidate to provide detailed information about his employment and personal history and to disclose any criminal record or instance in which he was the subject of a complaint, investigation or disciplinary action.

NASD's Entry into the Options Business

Now on p. 36.

- Page 44: "The Options Market"

In the interest of timeliness, the report would be improved by including a reference to the start-up of the NASD's NASDAQ Options Program in September 1985 with the introduction of an index option product. The beginning of this program was the culmination of years of effort on the part of many people both inside and outside of the NASD. That it occurred at all points up a major strength of the current self-regulatory process. The NASD's Options Program demonstrates the capacity of this process to marshal the efforts of many securities industry participants toward accomplishing a goal to benefit the securities market and public investors.

It also marks the beginning of standardized option products in the over-the-counter securities market, thus making it as important a chapter in the history of the securities industry as the start-up in 1973 of standardized options trading in listed securities. In addition to the introduction of other index option products, the NASD expects to begin trading individual stock options on certain actively traded NASDAQ National Market System securities during the first half of 1986.

Suggested Language Change

Now on p. 36.

- **Page 44: "The Options Market"**

Now on p. 37.

We believe that the second paragraph on page 45 could be made to be more precise if it were replaced with the following:

> From the passage of the Exchange Act of 1934 until 1973 when the Chicago Board Options Exchange (CBOE) began operation, options were traded only in the over-the-counter (OTC) market. In the early 1930s, a series of congressional and private studies of stock exchange practices exposed numerous manipulations and fraudulent activities involving the use of options in manipulative pools in the underlying securities. Consequently, early drafts of the bill that ultimately became the Securities Exchange Act of 1934 would have prohibited options trading on national securities exchanges. However, the Congress ultimately gave the SEC broad discretion to regulate options trading; in 1973 the SEC approved the Chicago Board of Trade's (CBOT) pilot program to establish the CBOE and a secondary market in standardized options.

See comment 1.

Additional Comment

Now on pp. 47 and 57.
See comment 2.

In two sections of the report, discussion of NASD regulatory activities is preceded by the phrase "According to NASD officials" (see pages 60 and 82). In no other place in the report are the activities of other organizations so qualified. Since our activities in each of these areas can be easily documented (and we invite your review of them), we urge that, for the sake of consistency, the introductory phrase be deleted.

* * *

The NASD appreciates this opportunity to provide its comments to the General Accounting Office on this draft report. With the inclusion in the final report of the information presented here, the GAO will perform a great service for readers of the report by providing them with a document that presents an accurate and timely portrayal of the securities industry's system of self-regulation. If you have any further questions or observations, please do not hesitate to contact us.

Sincerely,

Douglas F. Parrillo
Senior Vice President
Communications

The following are GAO's comments on the National Association of Securities Dealers' letter dated February 7, 1986.

GAO Comments:

1. We believe the original paragraph on page 37 is sufficient.

2. Throughout the study, there are many references to information provided by officials of a particular organization. For example, see pages 43, 47, 53, and 60.

Advance Comments From the American Stock Exchange

86 Trinity Place
New York, New York 10006
212 306-1160

Richard O. Scribner
Executive Vice President
Legal and Regulatory Affairs

American Stock Exchange

January 31, 1986

Mr. William J. Anderson
Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

This will acknowledge with thanks your letter of November 19, 1985 enclosing a draft of the staff study, "Self Regulation in the Securities and Futures Industries: How it Developed and How it Works," and requesting our comments thereon. Since November, we have been accorded the opportunity to review and comment on subsequent drafts of the study, which reflect previous informal comments by this exchange and other self-regulatory organizations.

We wish to confirm that the most recent draft of the study, received on January 30, 1986, is fairly reflective of our previous comments and concisely describes self-regulation in the securities industry, and we have no further comments on it.

We compliment the GAO on the outstanding work of its staff in compiling this study and have been pleased to offer our assistance in its preparation.

Very truly yours,

Richard O. Scribner

AMEX

Advance Comments From the Commodity Futures Trading Commission

COMMODITY FUTURES TRADING COMMISSION
2033 K STREET, N.W., WASHINGTON, D.C. 20581

OFFICE OF
THE EXECUTIVE DIRECTOR

January 17, 1986

Honorable William J. Anderson
Director
U. S. General Accounting Office
Wasington, D. C. 20548

Dear Mr. Anderson:

Thank you for the opportunity for the staff of the Commodity Futures Trading Commission to comment on the draft GAO staff study entitled "Self Regulation in the Securities and Futures Industries: How It Developed and How It Works." I understand that the Commission staff have worked with GAO staff and are satisfied that most of the comments made by CFTC will be incorporated in the final version of the study.

The report is an overview of broad-ranging, complicated subject matters. The commodities markets have become increasingly complex as new instruments, including options on futures and physicals, have emerged. Therefore, it is important to note that while staff have indicated that the descriptions in the study are accurate, they may be oversimplified and cannot be endorsed as a complete explanation of the topic. The Commission's staff would be happy to provide interested readers with further information on any of the topics covered in the report.

Sincerely,

MOLLY G. BAYLEY
Executive Director

Advance Comments From the Chicago Mercantile Exchange

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

CHICAGO MERCANTILE EXCHANGE

Gerald D. Beyer
Senior Vice President
Legal and Regulatory Affairs
312/930-3114

February 6, 1986

Mr. William J. Anderson
Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

Thank you for providing the Chicago Mercantile Exchange with an opportunity to comment on your study entitled "Self Regulation in the Securities and Futures Industry: How it Developed and How it Works." The Chicago Mercantile Exchange has reviewed the General Accounting Office's study and, with the exception of the items discussed herein, has found that although the report does not discuss all aspects of the regulatory process respecting futures, it does adequately describe the items discussed. We recognize that a report of this type can only be a very general description of the process.

The items discussed herein are those which we deem significant. We are providing our comments for the express purpose of trying to insure that the document which is ultimately published by the General Accounting Office is as accurate as possible. Additionally, we have taken objection to those statements which have been made without adequate documentation and represent broad unfounded conclusions.

Our specific comments follow:

See comment 1.

1. With regard to the statement in Chapter 5 that "speculative excesses on the grain exchanges led to falling commodity prices, farm depression, and demand for federal regulation," we question its accuracy, and the General Accounting Office provides no supporting documentation for that proposition. We are unaware of any documented evidence that supports this statement and believe it to be inaccurate and inflamatory.

See comment 2.

2. The statement in Chapter 6 that risk disclosure statements are sent to customers because of the "inherent risk" in the futures market is misleading. All investments, including U.S. Government Securities, have some inherent risk. Risk disclosure documentation is required due to the perception that the potential for loss as a percentage of the initial investment is relatively high when compared with other types of investments.

30 South Wacker Drive Chicago, Illinois 60606 312/930-1000
LONDON: 27 Throgmorton Street EC2N 2AN NEW YORK: 67 Wall Street 10005 WASHINGTON, DC: 2000 Pennsylvania Avenue N.W. 20006

See comment 3.

3. The statement in Chapter 6 that "buyers and sellers of futures, unlike the vast majority of those buying securities, do not pay full price" is misleading. As we indicated in our discussions, this indicates a lack of understanding of the futures market. A futures contract does not have a monetary value as does a security or an option. It is not an asset. It merely gives the purchaser the right to profit from favorable market moves, and, at the same time, gives rise to obligations to pay as a result of unfavorable market moves. (See No. 4 below.)

4. The statement in Chapter 6 that "a Treasury Bond futures contract worth $100,000" can be purchased for as little as $2,000 is wrong. As we have indicated repeatedly, futures contracts are not assets and cannot be characterized as having a monetary value. One does not control $100,000 worth of Treasury Bonds by buying a futures contract. In addition, only by putting up full value, does one have the right to take delivery and then control the Bonds.

See comment 4.

5. The statement in Chapter 6 that "when the [futures] account falls below a specified level called "maintenance margin", additional cash must be deposited by the customer to restore the account to a level of the maintenance margin", is incorrect. When a futures account falls below the specified minimum maintenance margin level, the account must be restored to the initial margin level. This is required by CME Rule 827.D.

See comment 5.

6. The statement in Chapter 6 that the failure by a customer to meet a margin call may result in the liquidation of the futures position with the broker taking a commission and the remainder returned to the customer, is misleading. The implication is that there is a relationship between a forced liquidation of a futures position due to the failure to meet a margin call and commission fees. In actuality, there is none. While there is a commission charge for the purchase and sale of a futures contract, it has nothing to do with the failure to meet margin calls.

See comment 6.

7. The description of the mechanics of the customer order system omits a critical step in the order execution process. The report fails to mention that after the executive relays the customer order by telephone to the firm's floor order clerk, the clerk must write up the customer order, time-stamp the order, and then relay the order to the floor broker in the designated trading pit. Writing up and time-stamping customer orders is required by CFTC regulation and CME rules.

See comment 7.

8. The statement in Chapter 6 that rules relating to trading procedures and memberships must be submitted to the CFTC at least ten days before they go into effect is misleading. The proper description is set forth in the Commodity Exchange Act §5a(12) and CFTC Regulations §1.41(c) and (d), wherein certain rule changes which do not deal with terms and conditions of futures contracts are exempt from the ten day requirement, such as procedures and forms for the purchase, sale or transfer of memberships.

See comment 8.

9. The statement that a trader who exceeds position limits could be in a position to "corner" or "squeeze" the market and manipulate the price of a contract because of the large number of contracts controlled, is misleading. It does not follow that a person who has a position in excess of the speculative limit is in a position to manipulate the market. Generally, the limits are so low that a person who exceeds them is not in a position to manipulate the market.

See comment 9.

10. The description in Chapter 6 of the principal SRO disciplinary committee as the Business Conduct Committee, is an accurate description of the Chicago Board of Trade's system. However, it should be noted that at the Chicago Mercantile Exchange, situations involving trade practice abuses are usually reviewed by the Floor Practices Committee whereas other potential rule violations are usually reviewed by the Business Conduct Committee. In both cases, the Probable Cause Committee reviews most investigations to determine whether charges should be issued, whether the matter should be closed, and, when appropriate, refers the matter to the respective committee.

See comment 10.

11. The statement in Chapter 6 that losing parties to a Member/Customer arbitration at the CME may appeal to the CME Board of Governors, is incorrect. Member/Customer arbitration decisions at the CME are final. Member-to-Member arbitration decisions may be appealed to the Board of Governors.

We appreciate the opportunity to submit these comments to the General Accounting Office and sincerely hope that it clarifies some of the misleading statements and inaccuracies contained in the study. If additional information with regard to the operation of the Chicago Mercantile Exchange as a self-regulatory organization is required for further studies, we will be pleased to cooperate.

Sincerely,

Gerald D. Gay

GDG/crb

The following are GAO's comments on the Chicago Mercantile Exchange's letter dated February 6, 1986.

GAO Comments:

1. We have revised the sentence to read "During the 1920's, falling commodity prices, farm depression, and speculative excesses on the grain exchanges led to demands for federal regulation," on page 67. This information is specifically contained in a report done by the Committee on Agriculture, Nutrition, and Forestry of the United States Senate concerning the Futures Trading Act of 1978. See Committee Print, 97th Congress, 2nd session, January 1979, pp. 129-132.

2. Changed "inherent" risk to "high" risk on page 71.

3. Our purpose is to show the leveraging aspect of controlling a futures contract. We have reworded this section on page 71, in accordance with the CME's comments, to clarify this point.

4. Changed "maintenance" to "initial" on page 71.

5. If a liquidation occurs, funds are returned to the customer after brokerage fees are taken for closing out the position. We have added wording to show that these fees are normal, on page 71.

6. Added "the clerk then writes up the order, time-stamps it, and then..." on page 74.

7. Revised "with limited exceptions, all other rules such as..." on page 77.

8. This statement is technically correct. However, we have modified the statement to show that a violation of these limits would not necessarily lead to a corner or squeeze of the market. See page 81.

9. Reference to the "Business Conduct Committee" has been deleted, on page 89.

10. Revised to read "Customer arbitrations at the CME and CBT are final," on page 92.

Advance Comments From the Chicago Board of Trade

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Chicago Board of Trade

Frederick J. Grede
Vice President
Administration and Planning

February 6, 1986

Mr. William J. Anderson
Director, General Government
Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

The Board of Trade of the City of Chicago has reviewed the preliminary draft of the General Accounting Office's report on the regulatory structure of the securities and futures markets. We thank the General Accounting Office for the opportunity to respond to the draft report and respectfully submit the following observations with respect to the report.

Now on p. 20.

PAGE 19

See comment 1.

The report implies that the dramatic growth of futures markets has raised concerns that unsophisticated investors may lose money from trading new products and that concerns about the disruptive effects of new products and trading strategies continues.

The Board of Trade is not aware of any specific allegations of these concerns and expresses the observation that these comments on the surface are misleading.

Now on p. 62.

PAGE 89

See comment 2.

The report implies that the three reasons cited are the only reasons for establishment of federal regulation of the futures market.

We believe that these three comments left alone again present a misleading picture.

LaSalle at Jackson
Chicago, Illinois 60604
312 435 3606

Mr. William J. Anderson
February 6, 1986
Page Two

Now on p. 67.

PAGE 97

See comment 3.

The portrayal of commodity exchanges as fostering unbridled speculation, recurrent market manipulation and spectacular price fluctuations is objectionable.

Now on p. 67.

PAGE 98

See comment 4.

The statement that "during the 1920's, speculative excesses on the grain exchanges led to falling commodity prices and farm depression" are unsubstantiated. The Board of Trade desires to know the origin of this particular statement.

Now on p. 68.

PAGE 100

See comment 5.

Again, the report implies that federal regulation or the necessity of federal regulation is grounded in the market's susceptibility to excessive speculation, manipulation, fraud or other irresponsible practices. We question the derivation of these statements.

Now on p. 71.

PAGE 103

See comment 6.

While the introduction and definition of margin in the futures market is an accurate portrayal, the implication that an individual can purchase a Treasury Bond Futures contract worth $100,000 by putting down as little as $2,000 is again misleading.

Financial futures contracts are settled on a daily basis and the $2,000 good faith deposit represents 100% of the maximum price fluctuation. Because futures markets generally have price limits, margin can be kept relatively low, since the maximum permissible daily price fluctuations have been accounted for.

We remind the GAO that in the securities markets, transactions are usually not settled for a five-day period or more. In futures markets, financial obligations are settled daily.

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Now on p. 74.

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See comment 7.

The report states that although trading on exchanges is by open outcry and competitive, it is not open to the public. Again, we believe the statement is misleading.

Futures trading is open to the public, but access to the trading floor is restricted, as it is on all futures and securities exchanges.

Now on p. 75.

PAGE 111

See comment 8.

The word "finalized" does not adequately describe what happens to futures contracts at the Clearing Corporation. Finalization occurs when offset or delivery takes place. The Clearing Corporation's role is better described as "clearing" or "bookkeeping" or "matching" or something similar thereto.

PAGE 111

The Clearing Corporation only stands in place of the clearing member if the clearing member defaults, not in place of an individual customer to an individual customer. The statement "buyer to every seller" could be misconstrued.

PAGE 111

Trades are not submitted at the end of each day. The Clearing Corporation receives trades throughout the day. Indeed, it will soon begin an experimental program of continuous matching.

Now on p. 76.

PAGE 112

See comment 9.

While the report discusses both clearing member margin deposits and customer margin requirements, it does not mention that clearing members are required satisfy their obligations to the clearing house by the opening of business the following morning.

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Also, in many situations, the clearing house has the ability to call for additional margin deposits and those margin deposits must be met within one hour.

Now on p. 82.

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See comment 10.

Positions in excess of a specific number are required to be reported to the Board of Trade and deemed to be large traders. While accounts that hold more than 5% of contracts in any particular commodity are closely monitored, reporting information is generated on many more accounts than just those with more than 5% of open interest.

The statement that Exchange staff do not review all trading in every contract is again misleading. The Exchange does review certain information from all contracts daily.

Now on p. 82.

PAGE 123

See comment 11.

The Board of Trade also monitors its regular warehouses to ensure that storage facilities comply with regulatory requirements and that registered warehouse receipts are backed by physical commodities.

Now on p. 83.

PAGE 124

See comment 12.

Large customer positions are also required to be reported to the Exchange on a daily basis. The Exchange similarly contacts market participants when conducting market surveillance.

The exchanges also work closely with the CFTC in monitoring market congestion situations.

In conclusion, we thank the GAO for the opportunity to respond to this report and look forward to reviewing the final report of the General Accounting Office upon completion.

Sincerely,

Frederick J. Grede

cc: John A. Rose

The following are GAO's comments on the Chicago Board of Trade's letter dated February 6, 1986.

GAO Comments:

1. These concerns were raised in hearings before two House Subcommittees of the Committee on Energy and Commerce concerning amendments to the Commodity Exchange Act and other matters. For example, see Hearings of April 23 and June 7, 1982, Serial #97-160, p. 169. In addition, these concerns were also addressed in Senate Report #97-485 of the Permanent Subcommittee on Investigations dealing with Commodity Investment Fraud. See page 1 of this July 13, 1982 report.

2. The reasons cited in the report are those which are contained in the Commodity Exchange Act, as amended, and are also specifically contained in the Senate Committee on Agriculture, Nutrition, and Forestry's January 1979 report covering the Futures Trading Act of 1978, pp. 130-136.

3. The statement specifically refers to how farmers viewed commodity exchanges and is contained in the report, cited above, done by the Committee on Agriculture, Nutrition, and Forestry of the United State Senate concerning the Futures Trading Act of 1978. See Committee Print, 97th Congress, 2nd session, January 1979, pp. 129-132.

4. We have revised the sentence to read "During the 1920's, falling commodity prices, farm depression, and speculative excesses on the grain exchanges led to demands for federal regulation," on page 67.

5. We derived these statements from the Commodity Exchange Act and have added a reference to the Act, on page 68.

6. Our purpose is to show the leveraging aspect of controlling a futures contract. We have reworded this section of page 71 to clarify the meaning.

7. Revised by adding "floor" after "exchange," on page 74.

8. Changed "finalized" to "matched" and revised side-cap. Deleted "as the buyer every seller and to every buyer" and replaced it with "acting in place of a clearing member if the member defaults." Deleted "At the end of each day, all" and added "Throughout the day." These changes are on page 75.

9. Added "Clearing members are required to satisfy their obligations to the clearing organizations by the opening of business the following morning. Also, according to CBOT officials, in many situations, the clearing organization has the ability to call for additional margin deposits which must be met within one hour," on page 76.

10. It is not our intent to suggest or imply that the specific reports mentioned represent the universe of all SRO generated surveillance reports. In addition, our statement that not all trading in every contract is reviewed on a daily basis is consistent with CBT's comment that it reviews certain information from all contracts daily. Here, our intention is to show that exchange staff put more emphasis on analyzing trading in those contracts due to expire (for the reasons stated in the text) than on contracts not nearing expiration.

11. We have added CBT to the example, on page 82.

12. Added that large customer positions must be submitted to "the exchanges" and to the CFTC on a daily basis, on page 83.

Advance Comments From the Chicago Board Options Exchange

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

The Chicago Board Options Exchange

Arne R. Rode
General Counsel

LaSalle at Van Buren
Chicago, Illinois 60605 312 786-7400

February 19, 1986

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
441 "G" Street, N.W.
Washington, DC 20548

Dear Mr. Anderson:

Thank you for giving The Chicago Board Options Exchange the opportunity to review the January 29, 1986 draft of your proposed report respecting "Self Regulation in The Securities and Futures Industries." After review of the portion respecting the securities industry by myself and a number of my colleagues, we believe the factual data contained therein to be materially accurate with one exception. That exception relates to the discussion (at pp. 22-24) which includes options among the types of securities instruments used by corporations to raise capital.

Now on pp. 23-24.

The discussion of options at pp. 23-24 and at pp. 44-46 appears to relate to standardized options as listed and traded on national securities exchanges. Those options are issued by The Options Clearing Corporation ("OCC"), not by the corporations (IBM, GE, etc.) whose shares underlie the options. The capital flows are from the buyers to the sellers of the options through the OCC which interposes itself as the issuer and guarantor of listed options contracts. To the extent that options permit market participants to speculate on or to hedge against price moves in underlying securities, they are generally acknowledged to contribute to the efficiency and liquidity of the market in the underlying instruments. This added liquidity in the secondary market provides a substantial indirect benefit to issuers of stock. However, because exchange-traded options are not purchased from the corporate issuer of the underlying shares, they cannot be grouped with those instruments used by corporations to raise capital.

Now on pp. 23-24 and pp. 36-38.

See comments 1 and 2.

Thank you for this final opportunity to comment on your study.

Sincerely,

Arne Rode

ARR/nk

The following are GAO's comments on the Chicago Board Options Exchange's letter dated February 19, 1986.

GAO Comments:

1. We removed the discussion of options as capital raising instruments and have reinserted it as an additional securities product available to investors, all on page 23.

2. We added language on page 36 to show that options are issued by the Options Clearing Corporation and not by the corporations whose stock underlies the options.

Glossary

Associated Person	A person associated with any futures commission merchant, commodity trading advisor, commodity pool operator, or leverage transaction merchant as a partner, officer, or employee. Also, any person occupying a similar status or performing similar functions, in any capacity that involves: (a) the solicitation or acceptance of customers' orders (other than in a clerical capacity); or (b) the supervision of any person or persons so engaged.
At-The-Market	An order to buy or sell a futures contract at whatever price is obtainable when the order reaches the trading floor.
Bid	The bid is the price anyone has declared that they are willing to pay for a security, futures, or options contract at a given time.
Broker	An agent who handles the public's orders to buy and sell securities, futures, or options.
Bucketing	Directly or indirectly taking the opposite side of a customer's order into the handling broker's own account or into an account in which the broker has an interest, without execution of the order on an exchange.
Call	A right to buy a fixed amount of a given security or commodity at a specified price within a limited period of time.
Capping	Effecting commodity or security transactions shortly prior to an option's expiration date to depress or prevent a rise in the price of the commodity or security so that previously written call options will expire worthless and the premium received therefrom will be protected.
Churning	Excessive trading which permits a broker who controls an account to earn excessive commissions while disregarding the best interests of the customer.
Corner	Securing such relative control of a commodity that its price can be manipulated. In an extreme situation, cornering involves obtaining

	futures contracts requiring delivery of more commodities than are available for delivery.
Dealer	An individual or firm in the securities industry who buys and sells stocks and bonds as a principal rather than as an agent.
Dealer Option	A put or call on a physical commodity, not originating on or subject to the rules of an exchange, in which the obligation for performance rests with the writer of the option. Dealer options are normally written by firms handling the underlying commodity and offered to public customers, although the reverse may also be true.
Debt Instrument	A financial instrument issued by a corporation or government body where the purchaser becomes a creditor of the issuing institution rather than a part owner as occurs with the purchase of stock. A bond is a classic example of a debt instrument.
Deliverable Supply	The quantity of a commodity that conforms to, or can readily be made to conform to, the delivery requirement of the futures contract and is available to the sellers at a cost no greater than the commodity's actual commercial value.
Depository Trust Company	A central securities certificate depository through which members effect security deliveries between each other via computerized bookkeeping entries thereby reducing the physical movement of stock certificates.
Equity Security	A financial instrument sold by corporations, such as stock, where purchase constitutes a part ownership of the issuing corporation.
Equity Stock Index	An index made up of selected equity securities, such as the Standard and Poor's 100 index, which reflects, in a single number, the market values of the many different securities. This allows investors to profit from, or protect against, price movements in the stock market generally (or in particular segments of that market) rather than in individual stocks. These indices are sold as either futures or options products.

Fitness Check	Reviewing Federal Bureau of Investigation files to determine if there is evidence of an arrest record or conviction for the individual in question. At the Securities and Exchange Commission, files are reviewed to determine if the individual has committed any securities-related crimes and violations.
Floor Official	Members who are designated to supervise exchange floor operations.
Frontrunning	The practice of effecting an options transaction based upon non-public information regarding an impending large transaction in the underlying commodity or stock in order to obtain a profit when the options market adjusts to the price at which the transaction occurs.
Futures Commission Merchant	Individuals, associations, partnerships, corporations, and trusts that solicit or accept orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that accept payment from or extend credit to those whose orders are accepted.
Futures Contract	Exchange-traded contracts specifying a future date of delivery or receipt of a certain amount of a specific product. The commodities traded in futures markets include stock indices, agricultural products, metals, and financial instruments.
Hedging	Taking a position in a derivative instrument, such as futures or options, opposite to a position held in the underlying asset to minimize the risk of financial loss from an adverse price change.
Insider Trading	Trading securities on the basis of material nonpublic information relating to such securities.
Leverage Contract	A standardized agreement of 10 years or more duration calling for delivery of a commodity with payments against the total cost spread out over a period of time.

Limit Order	An order to buy or sell a stated amount of a security or a commodity at a specified price, or at a better price if obtainable, after the order is entered.
Listed Stock	The stock of a company which is traded on a securities exchange.
Manipulation	Buying or selling a security for the purpose of raising or depressing the price.
Margin	In securities, the amount paid by a customer when he uses his broker's credit to buy a security. In futures, it is the amount of money or collateral deposited by a customer (good faith deposit) with his/her broker, by a broker with a clearing member, or by a clearing member with the clearinghouse, for the purpose of insuring the broker or clearinghouse against loss on open futures contracts. The margin is not partial payment on a purchase. (1) Original or initial margin is the total amount of margin per contract required by the broker when a futures position is opened; (2) Maintenance margin is a sum which must be maintained on deposit at all times. If a customer's equity in any futures position drops to or under the level because of adverse price movement, the broker must issue a margin call to restore the customer's equity.
Margin Call	(1) A request from a brokerage firm to a customer to bring margin deposits up to original levels; (2) A request by the clearinghouse to a clearing member to bring clearing margins back to minimum levels required by the clearinghouse rules.
Market Order	An order to buy or sell a stated amount of a security or future at the most advantageous price obtainable in the market after the order is entered.
Mini-Manipulation	The temporary manipulation of an equity's price to affect favorably the price of a transaction in the corresponding option.

Mutual Fund	A company or trust which uses its capital to invest in other companies. Mutual funds sell their own new shares to investors and stand ready to buy back their old shares. The majority of mutual funds are also referred to as open-end funds because their capitalization is not fixed; they issue more shares as people want them.
NASDAQ Stock	The stock of a company which is included in the NASDAQ system.
Offer	The price at which a person is willing to sell a security or commodity at a given time.
Option	A right to buy (call) or sell (put) a fixed amount of a given asset at a specified price within a limited period of time.
Pegging	Temporarily raising or preventing the drop of the price of an underlying security or commodity to protect or enhance the value of an expiring option or futures position upon the same underlying security or commodity.
Position Limit	A limit on the number of options or futures contracts an account may have.
Put	A right to sell a fixed amount of a given stock or commodity at a specified price within a limited period of time.
Quotation Spread	The size or amount of the price difference between the bid and the offer of a reported quote.
Quote	The price at which given asset can be bought or sold at a given time.
Registered Representative	An individual who accepts buy and sell orders for customers at a securities firm.

Rights	When a company wants to raise more funds by issuing additional securities, it may give its stockholders the opportunity, ahead of others, to buy the new securities in proportion to the number of shares each owns. The piece of paper evidencing this privilege is called a right. Because the additional stock is usually offered to stockholders below the current market price, rights ordinarily have a market value of their own and are actively traded. In most cases, they must be exercised within a relatively short period. Failure to exercise or sell rights may result in monetary loss to the holder.
Seat	A membership on an exchange.
Self-Regulatory Organization	Designated groups of industry professionals equipped with quasi-governmental powers to adopt and enforce standards of member conduct. Their regulation is carried out under government supervision.
Short Sale	A transaction by a person who believes a stock will decline and sells it though he does not own any. For instance: A person instructs their broker to sell short 100 shares of ABC. The owner borrows the stock so he can deliver the 100 shares to the buyer. The money value of the shares borrowed is deposited by the broker with the lender. Sooner or later, the person must cover the short sale by buying the same amount of stock borrowed for return to the lender. If the person is able to buy ABC at a lower price than it was sold for, the profit is the difference between the two prices—not counting commissions and taxes. But if the person has to pay more for the stock than the price received, the difference between the two prices is the loss.
Specialist	A member of an exchange who handles transactions on the trading floor for the stocks for which he is registered and who has the responsibility to maintain an orderly market in these stocks. He does this by buying or selling a stock on his own account when there is a temporary disparity between supply and demand for the stock.
Speculative Position Limits	Limits that set a maximum on the futures positions a speculator can hold. Speculative position limits do not apply to futures positions that are hedged in the cash market.

Squeeze	A situation in which the lack of supplies tends to force those needing to buy futures contracts to cover their positions by offset at higher prices.
Stock Exchange	An organized market place for securities featured by the centralization of supply and demand and the transaction of orders by member brokers for institutional and individual investors.
Tick	Refers to a change in price up or down. An up tick or plus tick designates a transaction at a price higher than the preceding transaction. A down tick, or minus tick, is a term used to designate a transaction made at a price lower than a preceding trade.
Warrant	A certificate giving the holder the right to purchase securities at a stipulated price within a specified time limit or perpetually.
Wash Trades	Entering into, or purporting to enter into, transactions for the purpose of giving the appearance that purchases and sales are being or have been made without a change in beneficial ownership.

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